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Tricon Yum!

Yo Quiero  
**YUM!**



1998 Annual Report

WALL S

**Our Passion** Put a YUM on people's faces around the world...that special eating experience that makes you smile and creates lifelong customers. We'll do that with:

- Food you crave
- Comeback value
- Customer-focused teams

**Our jobs will be the best in the world for people who are committed to quality food and satisfying customers better than anyone.**

*We've had a yummy year!*

# Financial Highlights

(in millions, except for unit and share data)	1998	1997	% change better (worse)
number of stores:			
franchised and licensed	20,246	18,505	9
company	9,517	11,207	(15)
system	29,763	29,712	—
system sales (excluding non-core businesses, rounded)	\$ 20,600	\$ 20,500	1
company revenues	8,468	9,685	(13)
ongoing operating profit	768	672	14
facility actions net gain (loss) <sup>(a)</sup>	275	(247)	NM
unusual charges <sup>(b)</sup>	(15)	(184)	NM
operating profit	1,028	241	NM
net income (loss)	445	(111)	NM
basic earnings per common share <sup>(c)</sup>	2.92	N/A	
diluted earnings per common share <sup>(c)</sup>	2.84	N/A	
cash flows provided by:			
operating activities	674	810	(17)
refranchising proceeds	784	770	2

NM — not meaningful

(a) Included in 1998 was \$54 million (\$33 million after-tax) related to favorable adjustments to our 1997 fourth quarter charge. Included in 1997 was \$410 million (\$300 million after-tax) related to our 1997 fourth quarter charge. See Note 4 to the Consolidated Financial Statements.

(b) Included in 1998 was \$11 million (\$7 million after-tax) related to favorable adjustments to our 1997 fourth quarter charge. Included in 1997 was \$120 million (\$125 million after-tax) related to our 1997 fourth quarter charge and an additional \$54 million (\$34 million after-tax) writedown of our Non-core Businesses. See Note 4 to the Consolidated Financial Statements.

(c) Reported loss per share information for 1997 has been omitted as our capital structure as an independent, publicly owned company did not exist.

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The information contained in this annual report should be read in conjunction with the cautionary statements on page 42.

**1 Become renowned for an ownership and recognition culture that drives the best results in the industry**

**2 Drive superior same store sales growth through differentiated brand positioning and innovation**

## **our bold goals**

**3 Improve the unit level economics enough to drive shareholder value**

**4 Develop the most competitive, leveragable above-the-store cost structure in the industry**

**5 Expand the system aggressively and profitably by becoming a superior franchise company**

**6 Build a capital and asset structure that dramatically enhances shareholder value**

# Letter to Shareholders

**DEAR PARTNERS** We're pleased to report that 1998 was an outstanding year for Tricon, with solid progress made against every operational and financial goal we set for ourselves. Perhaps this is best reflected in your Tricon stock price, which soared 73 percent by year's end, making it an excellent investment by any standard. More importantly, we've set the stage for 1999 and beyond, and are confident we are executing against the key growth drivers that we believe will differentiate us from every other restaurant company in the world.

**PERSPECTIVE ON 1998** We clearly ended 1998 with tremendous momentum. For the first time in nearly a decade, all three of our brands in the U.S. delivered positive same store sales growth for the full year. We believe this important achievement is the result of our focus on both operational excellence at the store level and marketing innovation with new products and promotions. Despite the financial crisis in Asia, our international business posted strong results, with an 11 percent increase in operating profit. The growth was driven by our focus on key markets, which allows us to build scale and rationalize General and Administrative expenses, while expanding franchise opportunities elsewhere. Recognizing that two-thirds of our international profit comes from just seven countries, we decided to substantially reduce our equity markets from 27 to about 16 by the end of 1999, well on the way to our goal of about ten equity markets.

This solid performance drove our store level margins up nearly 200 basis points to 13.5 percent. About one-third of the improvement in margins came from our base stores, while the balance of the improvement came from the benefits of our portfolio actions and the strategic charge we took in the fourth quarter of 1997. Our ongoing operating profit jumped 14 percent to \$768 million, driven by strong same store sales, the powerful growth in margins and higher franchise fees. Importantly, our ongoing operating earnings per share grew 29 percent for the year.

We also forged ahead on our refranchising and debt reduction targets. Strong demand in the market led to the refranchising of nearly 1,400 units — almost equaling the record number of units we sold in 1997. As a result, we made significant progress against our strategy to reduce our ownership to 20–25 percent of the system. The units refranchised, together with the closure of 661 units, drove our company ownership to 32 percent by year's end, six points below our 1997 ownership level. The \$600 million we received from the sale of these units, plus cash from our ongoing operations, enabled us to pay down over \$1 billion of debt last year, almost two years ahead of our original target. As expected, worldwide revenues from company sales and franchise fees declined by 13 percent due to our refranchising efforts and unit closures.

In terms of marketing and innovation, KFC had great success in the U.S. with Popcorn Chicken and Colonel's Crispy Strips, giving customers "food on the go" options in addition to the Colonel's Original Recipe and Extra Crispy chicken. KFC also re-introduced the Colonel in an animated advertising campaign, raising awareness to a whole new level for chicken lovers. Taco Bell hit a home run with its successful launch of Gorditas, reinventing the taco for the first time since Taco Bell's founder, Glenn Bell, introduced them over 35 years ago... not to mention Taco Bell's little Chihuahua featured in its advertising and on the cover of this Report. Meanwhile, Pizza Hut had a turnaround year, after introducing The Sicilian Pizza to rave reviews. Along with Pan Pizza, the most popular pizza in the world, Stuffed Crust and Thin 'n Crispy pizzas, Pizza Hut is delivering on its commitment to serve "The Best Pizzas Under One Roof." Internationally, we had strong same store sales growth in major markets like Mexico and the United Kingdom, and we built nearly 900 new units outside of the U.S., primarily through our franchisees and licensees.





#### 1999 PERSPECTIVE

We believe we've laid the groundwork in 1998 for another powerful year in 1999. We expect system sales to grow four to five percent, with the addition of 1,500 units, mostly by our franchisees and licensees. Our company revenues will continue to decline, reflecting the loss of sales from the units we sold or closed in 1998 and an additional 800–900 units we expect to rebrand in 1999. Franchise fees, however, should grow in the low teens as a result of franchisees building new units and acquiring former company-owned stores. We anticipate paying down about \$400–500 million of debt, reducing our balance to just over \$3 billion by year's end.

With cost savings, productivity enhancements and volume leverage, we expect to generate about a 100 basis point margin improvement, about half coming from our base stores and the other half coming from our portfolio actions. We also anticipate reducing our G&A by about \$50 million in 1999, despite continued spending on necessary Y2K initiatives and other system enhancements. In total, we expect our operating profit to grow in the mid-teen range, and when coupled with about an eight percent expected decline in net interest, operating earnings should be up just over 20 percent.

Our pipeline of new products and marketing in 1999 is far more exciting than it was at this time in 1998, beginning with the recent successful launch of Pizza Hut's "Big New Yorker" pizza. This new pizza, introduced in time for the Super Bowl, drove all-time record sales at Pizza Hut and we anticipate even greater results throughout the year. In the second half of 1999, KFC will launch a delicious new line of chicken sandwiches, providing our U.S. entry into this \$4 billion category in which we essentially have a zero share today, while strengthening our lunchtime business. Taco Bell also will introduce a dinner-time value meal which will enhance our after-5:00 pm business, complementing our strong lunch business. Overlaying these new products will be an exciting, exclusive global restaurant tie-in with the new *Star Wars* movie, Episode 1 — *The Phantom Menace*, scheduled to premiere on May 21 in the U.S. We'll be encouraging our customers to visit all three of our restaurant concepts with one blockbuster promotion.

So as you can see, we're very enthusiastic about our growth and financial prospects for 1999.

#### SET THE STAGE FOR FUTURE GROWTH

While we've given you our perspective on the company's positive performance in 1998 and our outlook for 1999, we want you to know we're focused on six "Bold Goals" to continue to drive our business results well into the future. These bold goals will help shape our management efforts:

First, we want to **become renowned for an ownership and recognition culture that drives the best results in the industry.** Let's face it: high employee turnover in the food service business is a reality, often exceeding 200 percent per year at the crew level. We believe the key to reducing this problem is highly motivated, qualified Restaurant General Managers (RGMs), since they're the ones leading the customer-focused teams. Our RGMs are our Number One leaders. So last year we began giving each of our RGMs a one-time, \$20,000 stock option grant called YUMBUCKs, with the opportunity to earn even more options based on their restaurant's performance. Like you, our RGMs now have an ownership stake in our company and that's helping improve our business and reduce turnover.

Each of our restaurant companies has its own unique program to recognize outstanding restaurant teamwork across its system. And we're pleased to tell you that our recognition culture knows no geographic boundaries. From Bangkok to Boston, and London to Los Angeles, we're having fun recognizing our people who are driving customer satisfaction and getting

We clearly ended 1998 with **tremendous** momentum. For the first time in nearly a decade, **all three** of our brands in the U.S. delivered positive same store sales **growth** for the full year...ongoing operating **profit** increased 14%...and our ongoing operating EPS grew 29%.

financial results. In Puerto Rico, for example, we dramatically reduced annual crew turnover by establishing a recognition culture that rewards employees for delivering customer satisfaction.

We're also pleased that nearly 100 percent of Tricon's top 500 leaders have met or exceeded our internal stock ownership guidelines, demonstrating their confidence in our growth potential and helping us achieve leadership continuity across the system. You can bet we're going to continue to do all we can to build an organization where every tool — from training and recognition, to compensation systems — recognizes winning performance, promotes ownership and establishes continuity. This improves retention, drives performance and generates profits.

Our second goal is to **drive superior same store sales growth through differentiated brand positioning and innovation**. We have the dominant share of the chicken, pizza and Mexican quick service restaurant (QSR) categories and have the three most recognizable restaurant brands in those categories in the world. Our strategy to enhance that position is to capitalize on the uniqueness of each brand through more product innovation, memorable retail advertising and promotions, and service so good it drives sales. We also have a unique opportunity to combine any of our three powerful brands into a single restaurant to give our customers more choice and drive sales — an advantage no other restaurant company in our peer group enjoys.

Third, we are working to **improve the economics of our restaurants enough to drive shareholder value**. We recognize we need to run each restaurant like it's our only one. This means we're going to continue to sweat the details and exploit every opportunity we can find to drive margin improvement the hard way, by being smarter and doing things better. One way we won't achieve margin improvement is by shortchanging our customers.

To do all of that, we've been working closely with our top-performing franchisees and company operators to find more effective ways of attacking cost pressures. For example, we formed a unified food service purchasing cooperative with our U.S. franchisees. This new \$4 billion co-op is intended to leverage system scale to drive down costs by purchasing food, paper goods and equipment for all our U.S. restaurants across the Tricon system. We're also introducing new technologies to simplify operations and improve service time. And we're intensifying team training and RGM coaching across the system.

On the store level, we're committed to a new program called CHAMPS (Cleanliness, Hospitality, Accuracy, Maintenance, Product quality and Speed of service), developed by our international team and being introduced in the U.S. in 1999 at our company-owned and many franchised restaurants. With CHAMPS, we'll now train, measure and reward outstanding employee performance against a common customer standard at all of our restaurants, enabling us to run our restaurants more efficiently and effectively.

Our fourth Bold Goal is to **develop the most competitive, leveragable above-the-store cost structure in the industry**. Rather than duplicate effort across each of our companies, we're focused on a "one-time, one-way" execution wherever possible, leveraging our enormous scale to weed out complexity and redundancy. We reduced our general and administrative expenses by over \$50 million in 1998, and plan to reduce them by about \$50 million in 1999, by doing things one-time, one-way.



We've set the stage for **1999** and beyond, and are confident we are executing against the **key growth drivers** that we believe will **differentiate** us from every other restaurant company in the world.



As an example, we consolidated most of our Kansas support facility into our existing operations in Kentucky and Texas. We also completed the consolidation of our television network media buying for all three brands, making Tricon one of the dominant network advertisers in the U.S. and leveraging our clout.

Another goal is to **expand the system aggressively and profitably by becoming a superior franchise company**. Over the next few years, we plan to take our company ownership down to 20–25 percent of the system by selling more of our restaurants to franchisees who are good, experienced operators; and by strategically expanding our system. Of the 1,500 units we expect to add in 1999, about 1,300 will be opened by our franchisees and licensees. Although we already have more restaurants than any other company, we still have tremendous growth potential in the U.S. and abroad.

This past August we held our first-ever U.S. Franchise Leadership Summit, where company leaders and franchisees from all three brands met to discuss our “one-system” approach, share best practices, and explore cross-branded expansion opportunities. Our franchisees are as excited about our growth potential as we are.

Our last Bold Goal is to **build a capital and asset structure that dramatically enhances shareholder value** — what we also call YUM Value. YUM Value is the sum of three things: 1) we intend to get more out of our existing businesses; 2) invest in high return businesses; and 3) exit persistently low return businesses. We'll continue to create YUM Value with a sharpened focus on sales growth, margin improvement, strategic system expansion and elimination of unnecessary or redundant initiatives that don't add customer or shareholder value.

**PROSPECTS NEVER LOOKED BRIGHTER** Our Passion is to put a YUM on people's faces around the world with crave and rave food, comeback value and with customer-focused teams. Our goal is to do that better than any other restaurant company in the world. It's clear we're aggressively executing against our goals, both on the operational and financial front, and we believe we've created an infrastructure to sustain our sales and profit momentum for the long-term.

As you read through the following pages, you'll see a lot of beaming faces. The people of Tricon have good reason to be proud. Their achievements are a true testament to the success of our overarching strategy: invest in the people who will satisfy our customers better than anyone, and profitability follows. We'd like to thank the more than 600,000 employees across the Tricon system, our franchise partners and outstanding Board of Directors for their dedication and inspired ideas throughout this important first year.

We expect great things in 1999, and well into the millenni-YUM.

From all of us at Tricon, YUM to you,

**Andrall E. Pearson**  
Chairman and CEO

**David C. Novak**  
Vice Chairman and President



David C. Novak,  
Vice Chairman and President

Andra E. Pearson,  
Chairman and CEO

# our formula for success is working

1

2

3

people  
capability  $\Rightarrow$  customers  $\Rightarrow$  then, we  
first follow make more  
money

Our **RGMs** are our **#1** leaders. They're the coaches and **team-builders** in our restaurants, satisfying our customers better than anybody. We'd like you to meet a few of our best **leaders...**

**Marek Balawejder** — *Pizza Hut Restaurant General Manager, Poland* Marek received the TRI "Globe Award" for flawlessly running his restaurant and keeping employee turnover low, while growing his business. In any language the word for that is YUM.

**Mary Adams** — *Pizza Hut Restaurant General Manager* Mary received the "Big Cheese Award" for managing Pizza Hut's first restaurant conversion to the new dine-in/carry-out concept and "taking a risk and helping us succeed."



## people capability first

At Tricon, we find reasons to celebrate the achievements of others... and we have fun doing it! We take pride in our work and have a passion for excellence. We're talking about 600,000 motivated people in our entire system who love the restaurant business, putting smiles on our customers' faces. We know that when we recognize and reward great behavior, we'll have a charged-up, customer-focused team. So we've come up with some rather unusual awards to recognize leadership: Bulldogs

and Floppy Chickens at KFC, Big Cheese Awards at Pizza Hut, the Royal Order of the Pepper at Taco Bell, The Globe at TRI and a special YUM Award at Tricon. Winning one of these awards is a big deal in our company, because those who do are committed to quality food and satisfying our customers better than anyone. We say "show us a great restaurant and we'll show you a great RGM — our #1 restaurant leader." We'd like to introduce you to a few of them: Marek Balawejder has made training the



**Charmayne Jefferson — Pizza Hut Franchise Restaurant General Manager** Charmayne received the "Big Cheese Award" for running a restaurant that's an example for all of us, and "living day-to-day the principle that treating your team special is the key to success with customers."

**Jeanne Carr — Taco Bell Restaurant General Manager** Jeanne was recognized with a "Royal Order of the Pepper Award" for her "tremendous leadership in building a great team and delighting customers."

**Paul Nnamdi — KFC Restaurant General Manager** Paul is a 1998 "Bulldog Award" winner for being "a shining light focused on customer satisfaction."

cornerstone of his success as a Pizza Hut RGM in Lublin, Poland. In 1997, after just two years with TRI, Marek received a Globe Award for achieving eight consecutive 100% CHAMPSCheck scores, reducing employee turnover to 60%, and growing transactions 15%. Tony Kron, a Taco Bell RGM in New Albany, IN knows what it takes to satisfy customers. For 15 years, he's been preaching the virtues of speed to his team. "There's a direct link between speed of service and sales growth," Tony says — and he should know. He's seen sales grow 13% in a year's time,

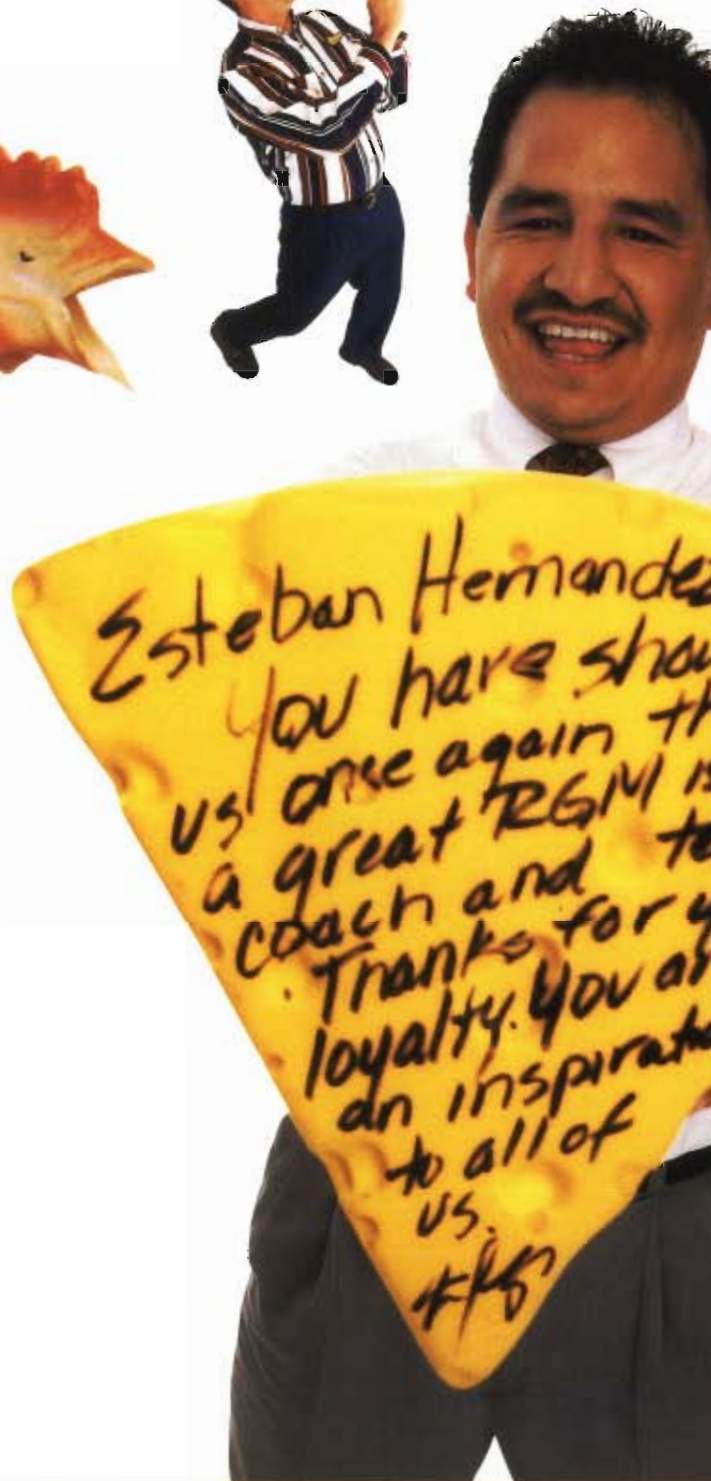
winning Tricon's YUM Award for leading that success. Esteban Hernandez, a Pizza Hut RGM in L.A., won a Big Cheese Award for coaching his team. During his six years as an RGM, Esteban has achieved a remarkably low annual crew turnover of just 56% (that's in an industry where a 200% crew turnover is normal).

Capable managers also show flexibility. Mary Adams, a Pizza Hut RGM in Columbia, SC, worked through the chaos of contractors and painters last year as they remodeled her restaurant into a first-of-its-kind dine-in/carry-out concept. She received a

**Raymond Wong — KFC Franchise Restaurant General Manager** Raymond's success at "building KFC sales to \$2 million!" at his restaurant earned him a "Floppy Chicken Award."

**Tony Kron — Taco Bell Restaurant General Manager** Tony received the "YUM Award" for growing sales by 13 percent and for beating profit projections by \$200,000.

**Esteban Hernandez — Pizza Hut Restaurant General Manager** Esteban received his "Big Cheese Award" for being a great coach and teacher.



Big Cheese Award for her willingness to take a risk and experiment with the new concept. Twenty-five years ago, when Jeanne Carr began working at Taco Bell in Toledo, OH, she considered it a good day when the restaurant made \$150 (those days are long over, thank goodness!). Jeanne's had a lot to do with boosting the business. Today, she's an RGM and a winner of the Pepper Award for her tremendous leadership in building a great

team and creating a program that sells Taco Bell products at schools in Toledo and Detroit.

Raymond Wong's tenacity sent his Sunnyvale, CA KFC — a franchised unit owned by Harman Management — beyond the \$2 million sales mark, earning him a Floppy Chicken Award in 1997. This year, the restaurant increased sales to \$2.4 million. Raymond focuses on quality food and service so good it drives sales. "Go Raymond... Go Raymond."

Nothing makes us happier than putting a **YUM** on our customers' faces around the world. We do that with quality **crave** and **rave** food, served at a **comeback value** by customer-focused teams.



Charmayne Jefferson didn't try to win a Big Cheese Award from Pizza Hut until she first talked it over with her team at their Walla Walla, WA franchised restaurant. "It meant we were going to have to excel, to work hard to achieve the goal," she says. "It had to be a team decision." The team came through with flying colors — her restaurant achieved an 8.4% growth in sales in 1998, with \$30,000 in incremental sales through community involvement work, while obtaining perfect customer service scores.

Paul Nnamdi, a native of Nigeria, brings an extra high level of energy to his KFC in Bell, CA, but he thinks "success comes from teamwork, not individual behavior." Last year, Paul received a Bulldog Award for outstanding customer service. "I tell my team to see people as 'guests,' not 'customers.' When you view them as customers, they become statistics. But when you treat them as guests, it becomes personal." We agree, Paul.



## satisfying our customers...

Our business is all about serving **YUMMY** food. Quality food, at a comeback value served by restaurant teams focused on service so good it drives our sales. We're talking about food that's irresistible... food that makes your mouth water just *thinking* about it... and when you enjoy it at one of our restaurants or on the go, you can't help but say... "YUM!"

We added some YUMMY best sellers to our menu last year — **The Sicilian Pizza** at Pizza Hut, with garlic, oregano and basil

baked right into the crust, topped with a cheese herb seasoning and lots of your favorite toppings — served piping hot, with an intense flavor found in Sicilian-style cooking. **Can you handle it?** We also re-launched the ever-popular Stuffed Crust Pizza, with cheese baked in the crust — it's so delicious that we've seen many of our customers eating their pizza slices backwards! And millions of customers every day continue to enjoy Pizza Hut Pan Pizza, our most popular menu offering...



Kentucky Fried  
YUM!



## with yummy food

At Taco Bell, our Chihuahua led a whole new taco revolution with the introduction of **Gorditas**. This is a delicious new take on the taco, served in a warm, hearty flatbread. Featuring flavors and spices that only Taco Bell can provide... such as the Sante Fe, with smokey chipotle-mayo sauce, the Fiesta with a zesty fresh tomato salsa, or the classic Supreme, with tomatoes and sour cream. All come with your favorite taco meat, new all white-meat chicken or delicious marinated steak. Gorditas have become

Taco Bell's most successful new product, ever. **Viva Gorditas!** Taco Bell's other menu favorites include classic crunchy tacos served in an authentic yellow corn taco shell... and soft tacos and burritos, prepared on warm white-flour tortillas with all your favorite fillings. And Nachos BellGrande and Mexican Pizzas... all at a value sure to WOW our customers.

KFC also gave customers new reasons to come in and drive-thru with its *improved crispier* **Extra Crispy Chicken**, which



brings more C-R-U-N-C-H to chicken on the bone, and its new **Popcorn Chicken** — delicious all white-meat chicken chunks breaded for a mouth-popping experience — and introduced by our new animated Colonel who says, "At KFC, we do chicken right — and not just in a bucket, neither!" We also created a craving for Honey BBQ wings, a limited time offer that flew onto the scene, creating record level sales both in January and August. And who doesn't love our world-famous Colonel's Original Recipe,

made with a secret blend of 11 herbs and spices, Colonel's Crispy Strips, great KFC taste without the bones, and Chunky Chicken Pot Pie? Served with home-style sides of freshly prepared cole slaw, mashed potatoes and gravy, and hot buttermilk biscuits baked fresh in the restaurant...

**Mouth watering yet?** Well, our new menu line-up for 1999 promises to be just as exciting. Our Chefs Councils around the world have been busy cooking up some new recipes of quality food sure to put a YUM on our customers' faces.

**The Power of YUM** We've begun to operate as one system, leveraging our enormous scale and practicing team together, team apart while making efforts to wipe out not-invented-here bureaucracy. Rather than have three of everything, we now share everything from information systems and accounts payable, to purchasing food, paper goods, equipment and network media. We've also begun to combine two or all three brands under one roof. We call it "multi-branding" and it's a big deal for our customers. What's more, we now consolidate our market planning, placing the best restaurant concept at each site rather than having the concepts bid against each other for the property as they did before Tricon... One-time, one-way. As you'll read in the next few pages about each of our restaurant concepts, we're focused on growth through new product innovation, bold breakthrough marketing and improved training and systems to drive productivity. That's what will differentiate us from every other restaurant company in the world. Now you can begin to realize just how much power there is in the Power of YUM.



*KFC - We do chicken right!*

It took the bold business style of KFC founder Colonel Harland Sanders to pioneer the fast food franchising industry at an age when most people retire. Nearly a half-century later, that same bold spirit continues to drive the KFC system today.

KFC declared 1998 the "Year of the Customer." By focusing our efforts on initiatives to enhance our customers' experience, KFC registered record sales and profits, with system sales up nearly 5 percent over last year. Same store sales grew over 3 percent in 1998 — in a QSR segment that was essentially flat.

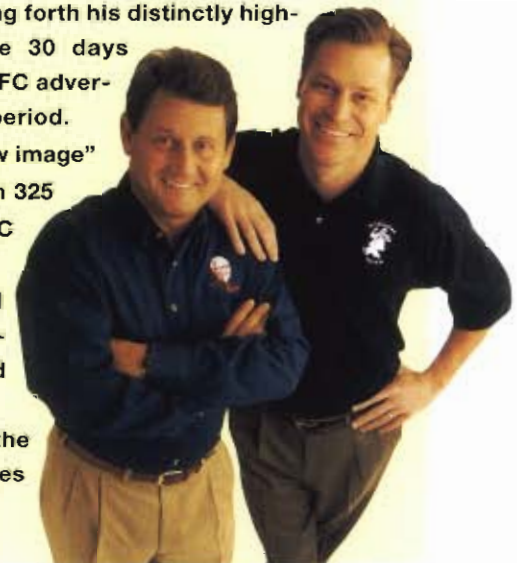
Much of that sales excitement came from delicious new products. New Extra Crispy Chicken proved that customers still love their chicken "on-the-bone." But it was new Popcorn Chicken that provided the most customer excitement in 1998. KFC company restaurants and franchisees alike set new records for quarterly sales.

A major factor in this sales surge was the bold, new animated Colonel advertising campaign that debuted in early September. Voiced by actor Randy Quaid, the animated Colonel will continue to set the stage for future promotions. The ads not only capture the Colonel's unmistakable look but also bring forth his distinctly high-spirited personality. The animated Colonel certainly broke through. In the 30 days following the Popcorn Chicken ad premiere, consumer tracking surveys showed KFC advertising awareness up 45 percent. Same store sales grew a record 12 percent that period.

In 1998, customers enjoyed their chicken meals and snacks at many more "new image" KFC restaurants. Franchisees and company operators built or remodeled more than 325 restaurants this year — the most single year activity in restaurant development for KFC in many years.

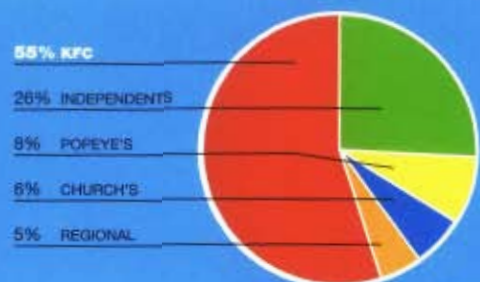
As KFC moves toward the 21st Century, we are committed to listening and responding to the voices of our customers, our franchisees and our front-line employees. These efforts will reinforce our role as the "chicken experts" — on the bone and on the go, and will help build long-lasting relationships with our customers.

KFC's recipe for success in the next millennium is as fresh today as when the Colonel introduced it — comeback value for the world's most delicious chicken recipes — all served up with a smile.



*Chuck Rawley President & Chief Operating Officer  
Terry Davenport Chief Concept Officer*

#### Chicken QSR Sales





## Pizza Hut: The Best Pizzas Under One Roof!

The Pizza Hut story mirrors the story of pizza itself. In the 40 years since Pizza Hut was founded in 1958, we've helped transform pizza from an ethnic specialty into the #1 Food in America. In doing so, Pizza Hut has become one of the great American brands and a dynamic market leader. In 1998, for our 40th birthday, our customers gave us the best possible present of all — the highest monthly average restaurant sales in our history! Our sales even beat last year's highly successful launch of The Edge Pizza in the same time period.

Needless to say, 1998 was a great year at Pizza Hut. What's driving this success? Simple. As we say in our advertising, we have "The Best Pizzas Under One Roof." In partnership with our franchisees, we're making that promise come to life by focusing on product quality, innovation, great service, careful financial and asset management and by building a true restaurant culture.

With more abundant and better quality toppings, our investment in product improvements is paying off — big time. Over the past three years, our customers rated us at an all-time high for product quality.

Pizza Hut's tradition of product innovation continued in 1998 with the launch of The Sicilian Pizza and the relaunch of our Stuffed Crust Pizza. Both drove sales, resulting in six consecutive quarters of same store sales increases. And our Pan Pizza continues to be the country's best selling pizza, proving once again that Pizza Hut is America's favorite pizza restaurant.

We've also made a determined effort to streamline our portfolio, eliminating many poor locations. The combination of extraordinary same store sales increases and a healthier portfolio, led to significantly improved margins, even at a time of historically high cheese prices and significant product investment.

For Pizza Hut, 1998 was great and the future looks strong: great new products, great promotions, great operations and, in partnership with our franchisees, great new assets. We just can't wait.



Aylwin Lewis Chief Operating Officer  
Mike Rawlings President & Chief Concept Officer

### Pizza QSR Sales





Yo Quiero Taco Bell!

These four words say it all when it comes to appreciating America's love affair with Taco Bell and our zesty menu. Exciting new products, breakthrough advertising and promotions, and a renewed dedication to providing a positive customer restaurant experience all led to growth and a very successful year.

1998 was the year of Gorditas — the introduction of this bold new line of products redefined how hungry people think about Taco Bell's food. Gorditas combine two of the hottest food trends sweeping the country today: the increased craving for spicier, more flavorful food and the desire for heartier-textured breads. More than one-quarter of a billion Gorditas were sold in 1998 alone.

Taco Bell also continued to underscore its value leadership position through offerings such as the 99-cent Nachos BellGrande and Mexican Pizza — all of which were promoted by the brand's most avid cheerleader, the Chihuahua.

The bilingual Mexican canine drew a collective "muy bueno" from consumers of all ages and backgrounds by declaring his hunger and love for Taco Bell. *USA Today* hailed the Chihuahua as a "Taco Goliath" who "leaves a mark on society and takes a bite out of the fast-food competition." *Life Magazine* declared the Chihuahua among the "100 Best Things About America Now."

The whole Taco Bell system worked hard to improve the customer experience in our restaurants — and our financial results were strong as a result. In all, system-wide sales reached \$5 billion in 1998. For the second consecutive year, the system experienced positive same store sales growth, with comparable unit sales advancing three percent. In turn, company restaurants saw margins improve by two percentage points.

By continuing to provide *Great tasting Mexican food anytime, and anywhere*, we'll have all of America exclaiming, "Yo Quiero Taco Bell" for many years to come. Viva Taco Bell!



Peter Waller President & Chief Concept Officer  
Tom Davin Chief Operating Officer

#### Mexican QSR Sales



73% TACO BELL\*

19% INDEPENDENTS

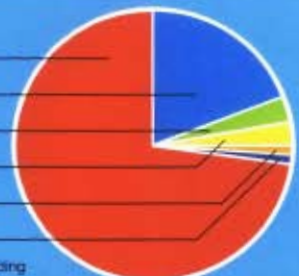
3% TACO JOHN'S

3% DEL TACO

1% TACO TIME

1% TACO BUENO

\*Taco Bell has a commanding market share lead.





## Tricon Restaurants International (TRI)

Building discipline worldwide. That's become the focus of our international business — and it's working great. In 1998, TRI operated restaurants in 27 countries, and by the end of 1999, we plan to reduce that to 16 countries by selling our units to franchisees. Ultimately, we'll reduce our company-ownership to about 10 key countries, while the rest of our system will be run by our franchisees and licensees. With this sharpened focus, we achieved a strong double-digit increase in operating profits for the third year in a row, despite the economic turmoil around the world.

Looking forward, we expect to open about 800 new units in 1999, primarily through our franchisees and licensees, while we strategically grow our equity business in a handful of countries, like China, Mexico, Taiwan, Thailand, Korea and the United Kingdom. To ensure that our customers receive the same standard of service at both company-owned and franchised restaurants, we've invested in training our employees around our customer-focused operating system, CHAMPS, and also have developed strong franchise support programs.

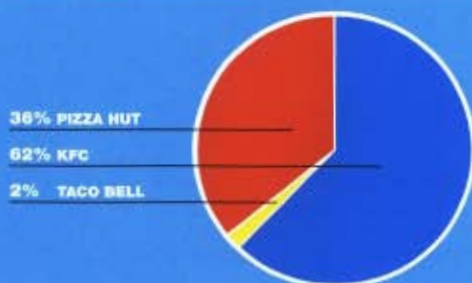
We also have made much progress establishing consistency in the way our products are presented to foreign markets, while offering menu variety to satisfy local tastes. So while our product offerings may vary by country, you can be sure all are made with the same high quality standards you've come to expect from KFC, Pizza Hut, and Taco Bell.

Our international business, like all other companies outside of the U.S., operated in a difficult world economic climate, especially in Asia. We quickly responded by developing a strategy of *affordable value* by offering customers new quality products at lower prices. It helped that we had some useful learnings from our experience in Mexico when the peso devalued in 1994.

Overall, Tricon's international outlook is terrific: We're focusing our equity investments better, reducing overhead, increasing our support of franchisees, clarifying our concepts, and cascading our culture, while building new restaurants and increasing our operating profits. What could be better?

Peter Hearl Executive Vice President & General Manager  
Pete Bassi President

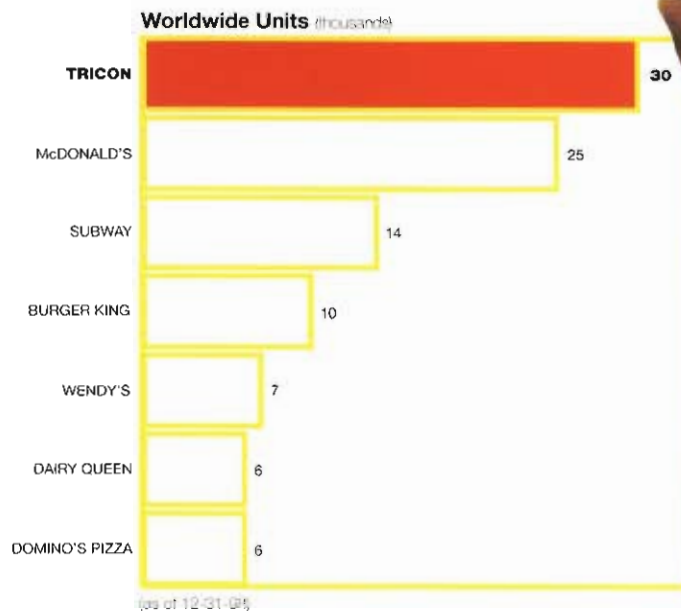
1998 International System Sales by Brand



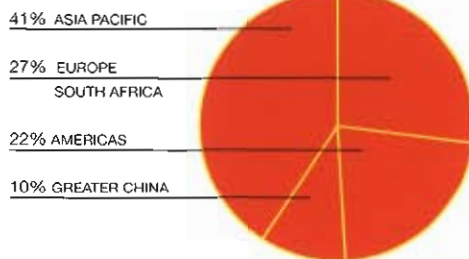
**A YUM Investment** With system sales growth, margin improvement, charged-up restaurant teams, the best franchisees in the business, and by leveraging our enormous scale, we'll make more money. Our formula for success is working: put our people capability first, because they'll satisfy our customers better than anyone. And then the profits will flow, making YUM a great investment.



# Tricon Facts

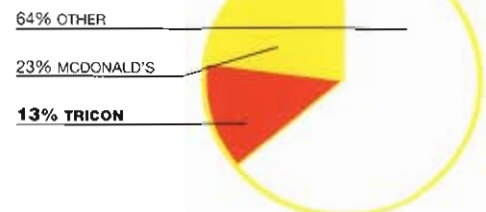


## Sources of System Sales in International Restaurants



## Worldwide Quick Service Restaurant Retail Sales

(% of total retail sales)\*



\*Based on Total Estimated Worldwide QSR Retail Sales of approximately \$160 billion

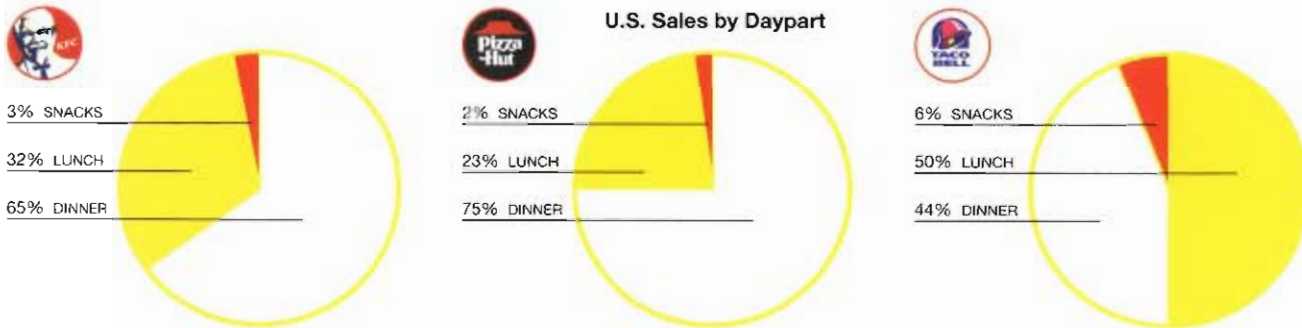
## Average U.S. Sales Per System Unit

(\$ in thousands) Compounded Annual Growth Rates

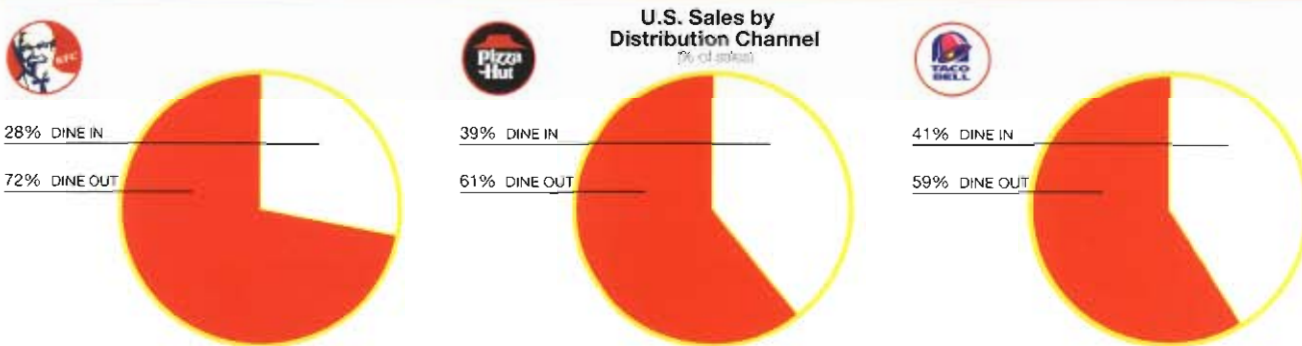
	1993	1994	1995	1996	1997	1998	5-year growth
KFC	\$ 685	\$ 706	\$ 733	\$ 775	\$ 786	\$ 817	4%
Pizza Hut	651	634	651	620	630	645	0%
Taco Bell	925	953	925	886	902	931	0%

Excludes sales from kiosks and other special outlets as well as Non-core Businesses.

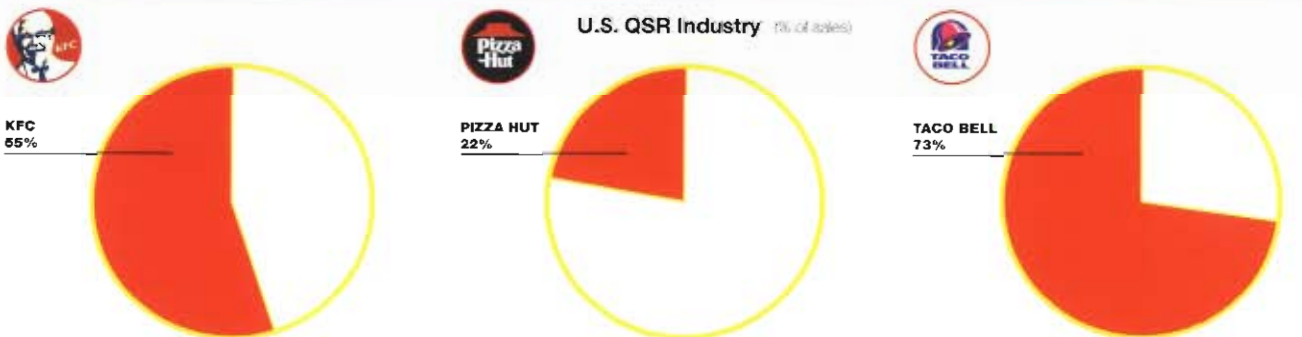




Sales across our brands are driven by dinner and lunch. Marketing innovations like new dayparts can help grow sales.



Most of our sales come from off-premise dining, which reflects customers' desire for convenient food.



#### Worldwide System Sales

\$ in billions (Compounded Annual Growth Rates)

	1993	1994	1995	1996	1997	1998	5-year growth
KFC	\$ 3.4	\$ 3.5	\$ 3.7	\$ 3.9	\$ 4.0	\$ 4.2	4%
Pizza Hut	4.8	4.9	5.1	4.9	4.7	4.8	0%
Taco Bell	3.7	4.2	4.4	4.6	4.8	5.0	6%
Total U.S.	11.9	12.6	13.2	13.4	13.5	14.0	3%
Total International	5.4	5.6	6.5	6.9	7.0	6.6	4%
Total	\$17.3	\$18.2	\$19.7	\$20.3	\$20.5	\$20.6	4%

Excludes sales from Non-core Businesses.

# Tricon Facts continued...

## Worldwide System Units

Consolidated Annual Growth Rates, Year-End 1993-1998

	1993	1994	1995	1996	1997	1998	5-Year Growth
<b>U.S.</b>							
KFC	5,094	5,115	5,137	5,108	5,120	5,132	—
Pizza Hut	7,965	8,348	8,648	8,759	8,698	8,471	1%
Taco Bell	4,495	5,358	6,126	6,669	6,768	6,880	9%
Total U.S.	17,554	18,821	19,911	20,536	20,586	20,483	3%
<b>International</b>							
KFC	3,939	4,292	4,492	4,753	5,117	5,291	6%
Pizza Hut	2,295	2,920	3,322	3,631	3,836	3,814	11%
Taco Bell	139	179	169	176	173	175	5%
Total International	6,373	7,391	7,983	8,560	9,126	9,280	8%
Total	23,927	26,212	27,894	29,096	29,712	29,763	4%

## Breakdown of Worldwide System Units

Year-End 1998

### U.S.

Company	Joint Venture	Franchised	Licensed	Total
KFC	—	3,441	58	5,132
Pizza Hut	—	4,041	1,445	8,471
Taco Bell	—	3,494	1,772	6,880
Total U.S.	—	10,976	3,275	20,483

### International

Company	Joint Venture	Franchised	Licensed	Total
KFC	482	3,619	61	5,291
Pizza Hut	638	1,956	232	3,814
Taco Bell	—	99	28	175
Total International	1,120	5,674	321	9,280
Total	1,120	16,650	3,596	29,763



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# Management's Discussion and Analysis

## Introduction

TRICON Global Restaurants, Inc. and Subsidiaries (collectively referred to as "TRICON," the "Company," "we" or "our") became an independent, publicly owned company on October 6, 1997 (the "Spin-off Date") via a tax free distribution of our Common Stock (the "Distribution" or "Spin-off") to the shareholders of our former parent, PepsiCo, Inc. ("PepsiCo"). See Notes 1, 2, 9, and 19 to the Consolidated Financial Statements. TRICON is comprised of the worldwide operations of KFC, Pizza Hut and Taco Bell (the "Core Business(es)"). The Spin-off marked our beginning as a company focused solely on the restaurant business and our three well-recognized brands, which together have more retail units worldwide than any other single quick service restaurant ("QSR") company. Separately, each brand ranks in the top ten among QSR chains in U.S. system sales and units. Our 9,000 plus international units make us the second largest QSR company outside the United States.

This Management's Discussion and Analysis ("MD&A") is structured in five major sections. The first section provides an overview and focuses on items that either significantly impact historical comparability or are anticipated to significantly impact our future operating results. The second analyzes our consolidated, U.S. and International results of operations. The next two sections address our consolidated cash flows and financial condition. Finally, there is a discussion of certain market risks and our cautionary statements.

For purposes of this MD&A, we include the worldwide operations of our Core Businesses and, through their respective dates of disposal in 1997, our U.S. non-core businesses. These non-core businesses consist of California Pizza Kitchen, Chevys Mexican Restaurant, D'Angelo's Sandwich Shops, East Side Mario's and Hot 'n Now (collectively the "Non-core Businesses"). Where significant to the discussion, we separately identify the impact of the Non-core Businesses.

In our discussion **volume** is the estimated dollar effect of the year-over-year change in customer transaction counts. **Effective net pricing** includes price increases/decreases and the effect of changes in product mix. **Portfolio effect** represents the impact on operating results related to our refranchising initiative and closure of underperforming stores. **System sales** represents our Core Businesses' combined sales of the Company, joint venture, franchised and licensed units. Where actual sales data is not reported, our franchised and licensed unit sales are estimated. **NM** in any table indicates that the percentage is not considered meaningful. **B(W)** in any table means % better(worse). In addition, throughout our discussion, we use the terms **restaurants, units** and **stores** interchangeably.

This MD&A should be read in conjunction with our Consolidated Financial Statements on pages 43-65 and the Cautionary Statements on page 42. Tabular amounts are displayed in millions except per share and unit count amounts, or as specifically identified.

## INTERNATIONAL OPERATIONS

In 1998, our international business accounted for 32% of system sales, 24% of total revenues and 21% of operating profit before unallocated and corporate expenses, foreign exchange gains, facility actions and unusual charges. We anticipate that, despite the inherent risks and generally higher general and administrative expenses of operations, we will continue to invest in key international markets with substantial growth potential.

During 1998, recognizing that two-thirds of our international profits were coming from seven countries, we decided to substantially reduce our number of primary equity markets from 27 to our ultimate goal of about ten markets. By the end of 1999, we expect to have only about 16 primary equity markets outside the U.S.

Given the significance of our international operations, it is important to consider that movements in currency exchange rates not only result in a related translation impact on our earnings, but also can result in significant economic impacts that affect operating results. Changes in exchange rates are often linked to variability in real growth, inflation, interest rates, governmental actions and other factors which may change consumer behavior and may impact our operating results. In addition, material changes may cause us to adjust our financing, investing and operating strategies; for example, promotions and product strategies, pricing and decisions concerning capital spending, sourcing of raw materials and packaging (see discussion on Asia below). The following paragraphs describe the effect of currency exchange rate movements on our reported results.

As currency exchange rates change, translation of the income statements of our international businesses into U.S. dollars affects year-over-year comparability of operating results. We identify material effects on comparability of sales and operating profit arising from translation of operating results in the MD&A. By definition, these translation effects exclude the impact of businesses in highly inflationary countries, where the accounting functional currency is the U.S. dollar.



Changes in currency exchange rates can also result in reported foreign exchange gains and losses, which are included as a component of our general, administrative and other expenses. We reported a net foreign exchange gain of \$6 million in 1998, compared to losses of \$16 million in 1997 and \$5 million in 1996. These reported amounts include transaction and translation gains and losses. Transaction gains and losses arise from monetary assets such as receivables and short-term interest-bearing investments as well as payables (including debt) denominated in currencies other than a business unit's functional currency. Translation gains and losses arise from remeasurement of the monetary assets and liabilities of our businesses in highly inflationary countries into U.S. dollars.

**Before currency impact, Asian system sales increased 8%.**

### ASIAN ECONOMIC EVENTS

The overall economic turmoil and weakening of local currencies against the U.S. dollar which began in late 1997 throughout much of Asia presented a challenging retail environment during 1998. The difficult economic conditions adversely affected the U.S. dollar value of our foreign currency denominated sales and profits ("translation") and reduced consumer demand as seen in reduced transaction counts, both of which impacted our 1998 consolidated results of operations.

Asian operations in such countries as China, Japan, Korea, Singapore, Taiwan and Thailand, among others, comprised approximately 34% of our international U.S. dollar translated system sales in 1998, versus 36% for 1997. Asian system sales declined \$254 million or 10% in 1998. Excluding the impact of foreign currency translation, Asian system sales increased 8% in 1998. System sales increases in China and Taiwan were partially offset by declines in Japan, Korea and South Asia.

Our Company revenues from Asia declined \$18 million or 3% in 1998. Included in our revenues are franchise fees, which decreased \$13 million, or 18%. Excluding the negative impact of foreign currency translation, our revenues from Asia increased approximately 16% in 1998. New unit development in China, Taiwan and Korea led the increase, partially offset by volume declines in Korea, China and Thailand.

Our operating profits from Asia declined \$27 million or 30% in 1998. Excluding the impact of foreign currency translation, operating profits decreased 7% in 1998. Lower margins in Korea and volume declines in both Korea and China were partially offset by new unit growth as well as increased store margins in China and Taiwan.

The discussion above reflects a change in the methodology we have used in 1998 to calculate the foreign currency translation effect attributed to Asia's system sales, revenues and operating profits in previous MD&As. We believe this revised methodology, which is consistent with the method we have historically used for total international, is preferable because it results in analytical relationships that are more consistent with our local currency operating results in Asia. Under the revised method, the decline in operating profits attributed to the effect of foreign currency translation is \$7 million less than previously disclosed.

Selected highlights of our recent operating results in Asia are as follows:

	1998	1997	% BW) vs. 1997
System Sales	\$ 2,271	\$ 2,525	(10)
% of International System Sales	34	36	
Revenues	\$ 496	\$ 514	(3)
% of International Revenues	24	22	
Operating Profit <sup>(a)</sup>	\$ 65	\$ 92	(30)
% of Total International Operating Profit <sup>(a)</sup>	34	54	

(a) Excludes facility actions net gain (loss), unusual charges and foreign exchange gains (losses)

In 1999, we will continue to work with our suppliers to reduce food costs and focus on increasing our everyday value offerings, and we expect to continue to cautiously seek out investment opportunities in Asia, drawing on lessons learned there, and from our experience in other countries which have faced similar problems in the past such as Mexico and Poland. The complexities of the international environment in which we operate make it difficult to accurately predict the ongoing effect of currency movements. Actual effects will be reported in our financial statements as they become known. However, we currently expect our sales and operating profits in Asia will improve in 1999 aided by the reduction of certain regional support costs and more stable sales trends.

### YEAR 2000

We have established an enterprise-wide plan to prepare our information technology systems (IT) and non-information technology systems with embedded technology applications (ET) for the Year 2000 issue, to reasonably assure that our critical business partners are prepared and to plan for business continuity as we enter the coming millennium.

Our plan encompasses the use of both internal and external resources to identify, correct and test systems for Year 2000 readiness. External resources include nationally recognized consulting firms and other contract resources to supplement available internal resources.

The phases of our plan — awareness, assessment, remediation, testing and implementation — are currently expected to cost \$62 to \$65 million from 1997 through completion in 2000. The new estimate is higher than our original estimate of \$40 to \$45 million. Our original estimate did not include approximately \$7 million in costs related to the accelerated implementation of replacement systems. Additionally, we have increased our estimates for the approximate costs of remediating subsequently identified applications and the greater than anticipated complexity of certain remediation and contingency planning activities. Our plan contemplates our own IT/ET as well as assessment and contingency planning relative to Year 2000 business risks inherent in our material third party relationships. The total cost represents less than

20% of our total estimated information technology related expenses over the plan period. We have incurred approximately \$35 million from inception of planned actions through December 26, 1998 of which \$31 million was incurred during 1998. We expect to incur approximately \$25 million in 1999 with some additional problem resolution spending in 2000. All costs related to our Year 2000 plan are expected to be funded through cash flow from operations.

**IT/ET STATE OF READINESS** We have now completed our inventory process of hardware (including desktops), software (third party and internally developed) and embedded technology applications. Completion of the inventory process significantly increased the previously reported tabulations of applications, as defined below, as more complete counts, primarily regarding desktop, hardware and ET were obtained. We have also implemented monitoring procedures designed to insure that new IT/ET investment is Year 2000 compliant.

Based on this inventory, we identified the critical IT/ET applications and are in the process of determining the Year 2000 compliance status of the IT/ET through third party vendor inquiry or internal processes. We expect to be substantially complete with the conversion (which includes replacement and remediation) and unit testing of the majority of critical U.S. systems in the second quarter of 1999. Although our original timeline has been extended for approximately ten critical applications, we now expect to be able to convert, consolidate, or replace all such applications by late summer. This timetable reflects certain delays attributable to identified incremental complexities of the remediation processes as well as slippage in the execution of our remediation plan. Further delays on these efforts or additional slippage could be detrimental to our overall state of readiness. Our international IT/ET efforts, as expected, have continued to lag behind our U.S. efforts. However, we believe our business risk is minimized by the predominant use of unmodified third party IT in our international business for which Year 2000 compliant versions already exist. Current plans call for timely conversion of critical international systems to these compliant versions. We will continue to closely monitor international progress. We expect to continue integration testing on remediated, replaced and consolidated U.S. and international systems throughout 1999.

The following table identifies by category and status the major identified IT/ET applications at December 26, 1998:

Category	Remediation/		Not
	Compliant	In-Process	Compliant
Third Party Developed Software	587	1,044	421
Internally Developed Software	118	472	113
Desktop	553	2,020	536
Hardware	608	1,785	342
ET	420	1,168	42
Other	69	212	5
	2,355	6,701	1,459

Note: We based the tabulations on the total inventory of identified "applications" that was completed at the end of 1998. We have defined the term applications (as used in this Year 2000 discussion) to describe separately identifiable groups of programs, hardware or ET which can be both logically segregated by business purpose and separately unit tested as to performance of a single business function. We will either replace or retire "Not Compliant" applications before Year 2000. Applications have been prioritized and are being remediated based on expected impact of non-remediation. Of the remaining 472 "In-Process" applications in the Internally Developed category, which by definition require internal remediation, less than half have been identified as critical.

**MATERIAL THIRD PARTY RELATIONSHIPS** We believe that our critical third party relationships can be subdivided generally into suppliers, banks, franchisees and other service providers (primarily data exchange partners). We completed an inventory of U.S. and international restaurant suppliers and have mailed letters requesting information regarding their Year 2000 status. We are in the process of collecting the responses from the suppliers and assessing their Year 2000 risks. Of approximately 550 suppliers considered critical, approximately 10% are high risk based on their responses and approximately 42% have not yet responded to inquiries to date. We expect to continue follow-up, but by mid-1999 we expect to source through alternate compliant vendors where possible. We will develop contingency plans in the first half of 1999 for U.S. and international suppliers that we believe have substantial Year 2000 operational risks.

We have sent letters to or obtained other information regarding compliance information from our primary lending and cash management banks ("Relationship Banks"). We will develop contingency plans by early 1999 for all banks that have not submitted written representation of Year 2000 readiness. We have limited the following table to Relationship Banks as we are currently preparing an inventory of U.S. depository banks and have just completed the inventory of international banks responsible for processing restaurant deposits and disbursements. We are following the process used for Relationship Banks to evaluate the Year 2000 risks for the U.S. depository and international banks.

We have approximately 1,200 U.S. and 950 international franchisees. We have sent information to all U.S. and international franchisees regarding the business risks associated with Year 2000. In addition, we provided sample IT/ET project plans and a report of the compliance status in Company-owned restaurants to the U.S. franchisees. In the early part of 1999, we plan to mail letters to all U.S. and international franchisees requesting information regarding their Year 2000 status. In the U.S., we intend to accumulate survey data and an inventory of point-of-sale hardware and software in use by our franchisees. We then



intend to contact POS vendors to assist the franchise community in determining Year 2000 compliance. Outside the U.S., our regional franchise offices will be conducting the franchise survey.

We have identified third party companies that provide critical data exchange services and mailed letters to these companies requesting Year 2000 status. We will develop contingency plans for companies that we believe have significant Year 2000 operational risks. Additionally, we are in the process of identifying all other third party companies that provide business critical services. We are planning to follow the same process used for the data exchange service providers.

The following table indicates by type of third party risk the status of the readiness process:

	Responses Received	Responses Not Yet Received
Suppliers	314	231
Relationship Banks	43	34
Service Providers	44	45
	401	310

Note: As we have not yet requested information from our individual franchisees regarding Year 2000 compliance status, this table contains no information regarding our franchisees. In addition, we have only included Relationship Banks due to incomplete data regarding depository and payroll banks.

The forward-looking nature and lack of historical precedent for Year 2000 issues present a difficult disclosure challenge. Only one thing is certain about the impact of Year 2000 — it is difficult to predict with certainty what truly will happen after December 31, 1999. We have based our Year 2000 costs and timetables on our best current estimates, which we derived using numerous assumptions of future events including the continued availability of certain resources and other factors. However, we cannot guarantee that these estimates will be achieved and actual results could differ materially from our plans. Given our best efforts and execution of remediation, replacement and testing, it is still possible that there will be disruptions and unexpected business problems during the early months of 2000. We anticipate making diligent, reasonable efforts to assess Year 2000 readiness of our critical business partners and will ultimately develop contingency plans for business critical systems prior to the end of 1999. However, we are heavily dependent on the continued normal operations of not only our key suppliers of chicken, cheese, beef, tortillas and other raw materials and our major food and supplies distributor, but also on other entities such as lending, depository and disbursement banks and third party administrators of our benefit plans. Despite our diligent preparation, unanticipated third party failures, general public infrastructure failures, or our failure to successfully conclude our remediation efforts as planned could have a material adverse impact on our results of operations, financial condition or cash flows in 1999 and beyond. Inability of our franchisees to remit franchise fees on a timely basis or lack of publicly available hard currency or credit card processing capability supporting our retail sales stream could also have material adverse impact on our results of operations, financial condition or cash flows.

## 1997 FOURTH QUARTER CHARGE

In the fourth quarter of 1997, we recorded a \$530 million unusual charge (\$425 million after-tax). The charge included estimates for (1) costs of closing underperforming stores during 1998, primarily at Pizza Hut and internationally; (2) reduction to fair market value, less costs to sell, of the carrying amounts of certain restaurants we intended to rebrand in 1998; (3) impairment of certain restaurants intended to be used in the business; (4) impairment of certain joint venture investments to be retained; and (5) costs of related personnel reductions. Of the \$530 million charge, approximately \$401 million related to asset writedowns and approximately \$129 million related to liabilities, primarily occupancy-related costs and, to a much lesser extent, severance. The liabilities were expected to be settled from cash flows provided by operations. Through December 26, 1998, the amounts utilized apply only to the actions covered by the charge.

The charge included provisions related to 1,392 units expected to be rebranded or closed. Our prior disclosure of 1,407 has been revised to eliminate a duplication in the unit count only of 15 units to be rebranded. Following is a reconciliation of the 1,392 units included in the charge to the remaining units at December 26, 1998:

	Units Expected to be Closed	Units Expected to be Rebranded	Total Units Included in the Charge
Units at December 27, 1997	740	652	1,392
Units disposed of	(426)	(320)	(746)
Units retained	(88)	(20)	(108)
Change in method of disposal	(109)	109	—
Other	6	(13)	(7)
Units at December 26, 1998	123	408	531

Although we originally expected to rebrand or close all 1,392 units by year-end 1998, the disposal of 531 units was delayed. This was primarily due to longer than expected periods to locate qualified buyers, particularly for international units, extended negotiations with some lessors and execution delays in consolidating the operations of certain units to be closed with other units that will continue to operate. We expect to dispose of the remaining units during 1999.

As we indicated in our third quarter 1998 Form 10-Q, we re-evaluated during the fourth quarter of 1998 our prior estimates of the fair market values of units to be rebranded or closed and re-evaluated whether to sell or close certain other units originally expected to be disposed of. We made these re-evaluations based primarily on the improved performance of Pizza Hut in the U.S. Largely as a result of decisions to retain certain stores originally expected to be disposed of, better-than-expected proceeds from rebrandings and favorable lease settlements on certain closed store leases, we have reversed \$65 million of the charge (\$40 million after-tax) in 1998. These reversals have increased 1998 facility actions net gain by \$54 million (\$33 million after-tax) and decreased 1998 unusual charges by \$11 million (\$7 million after-tax).

Of the \$530 million charge, approximately \$140 million represented impairment charges for certain restaurants intended to be used in the business and for certain joint venture investments to be retained, which were recorded as reductions of the carrying value of those assets. Below is a summary of the other activity related to the 1997 fourth quarter charge through December 26, 1998:

	Asset Valuation Allowances	Liabilities	Total
December 27, 1997	\$ 261	\$ 129	\$ 390
Utilizations	(131)	(54)	(185)
(Income) expense impacts:			
Completed transactions	(27)	(7)	(34)
Decision changes	(22)	(17)	(39)
Estimate changes	15	(7)	8
Other	1	—	1
December 26, 1998	\$ 97	\$ 44	\$ 141

We believe that the remaining amounts are adequate to complete our current plan of disposal. However, actual results could differ from our estimates.

We believe our worldwide business, upon completion of the actions covered by the charge, will be significantly more focused and better-positioned to deliver consistent growth in operating profit before facility actions. We estimate that the favorable impact on 1998 operating profit before facility actions related to the 1997 fourth quarter charge was approximately \$64 million (\$42 million after-tax), including \$33 million (\$21 million after-tax) from the suspension of depreciation and amortization in 1998 for the stores included in the charge.

As anticipated in our 1997 Annual Report on Form 10-K, the 1998 benefits of our 1997 fourth quarter charge of \$64 million were largely offset by incremental spending related to our Year 2000 issues of \$27 million and the decline in our Asian businesses of \$27 million in 1998 compared to 1997.

See Note 4 to the Consolidated Financial Statements for additional disclosures related to the components of the 1997 fourth quarter charge and to all facility actions.

## EURO CONVERSION

On January 1, 1999, eleven of the fifteen member countries of the European Economic and Monetary Union ("EMU") adopted the Euro as a common legal currency and fixed conversion rates were established. From that date through June 30, 2002, participating countries will maintain both legacy currencies and the Euro as legal tender. Beginning January 1, 2002, new Euro-denominated bills and coins will be issued and a transition period of up to six months will begin in which legacy currencies will be removed from circulation.

We have Company-owned and franchised businesses in the adopting member countries, which are preparing for the conversion. Expenditures associated with conversion efforts to date have been insignificant. We currently estimate that our spending over the ensuing three-year transition period will be approximately \$16 million, related to the conversion in the EMU member

countries in which we operate stores. These expenditures primarily relate to capital expenditures for new point-of-sale and back-of-house hardware and software. We expect that adoption of the Euro by the U.K. would significantly increase this estimate due to the size of our businesses there relative to our aggregate businesses in the adopting member countries in which we operate.

The speed of ultimate consumer acceptance of and our competitor's responses to the Euro are currently unknown and may impact our existing plans. However, we know that, from a competitive perspective, we will be required to assess the impacts of product price transparency, potentially revise product bundling strategies and create Euro-friendly price points prior to 2002. We do not believe that these activities will have sustained adverse impacts on our businesses. Although the Euro does offer certain benefits to our treasury and procurement activities, these are not currently anticipated to be significant.

We currently anticipate that our suppliers and distributors will continue to invoice us in legacy currencies until late 2001. We expect to begin dual pricing in our restaurants in 2001. We expect to compensate employees in Euros beginning in 2002. We believe that the most critical activity regarding the conversion for our businesses is the completion of the rollout of Euro-ready point-of-sale equipment and software by the end of 2001. Our current plans should enable us to be Euro-compliant prior to the requirements for these activities. Any delays in our ability to complete our plans, or in the ability of our key suppliers to be Euro-compliant, could have a material adverse impact on our results of operations, financial conditions or cash flows.

## Other Factors Affecting Comparability

### UNUSUAL CHARGES

In 1998, we had unusual charges of \$15 million (\$3 million after-tax) versus unusual charges in 1997 of \$184 million (\$165 million after-tax).

Unusual charges in 1998 included the following: (1) an increase in the estimated costs of settlement of certain wage and hour litigation and associated defense and other costs incurred; (2) severance and other exit costs related to strategic decisions to streamline the infrastructure of our international businesses; (3) favorable adjustments to our 1997 fourth quarter charge related to anticipated actions that were not taken, primarily severance; (4) writedown to estimated fair market value less costs to sell of our minority interest in a privately held non-core business, previously carried at cost, now held for sale; and (5) reversals of certain valuation allowances and lease liabilities relating to better-than-expected proceeds from the sale of properties and settlement of lease liabilities associated with properties retained upon the sale of a Non-core Business.

Unusual charges in 1997 included the following: (1) \$120 million (\$125 million after-tax) of unusual asset impairment and severance charges included in our 1997 fourth quarter charge described above; (2) charges to further reduce the carrying amounts of Non-core Businesses held for disposal to estimated market value, less costs to sell; and (3) charges relating to the

estimated costs of settlement of certain wage and hour litigation and the associated defense and other costs incurred.

#### ACCOUNTING CHANGES

In 1999, our financial results will be impacted by a number of accounting changes. These changes, which we believe are material in the aggregate, fall into three categories:

- required changes in Generally Accepted Accounting Principles ("GAAP"),
- discretionary methodology changes implemented to more accurately measure certain liabilities and
- policy changes driven by our financial standardization project.

Following is a discussion of those changes which have affected or will affect comparability.

**REQUIRED CHANGES IN GAAP** In 1999, we will adopt Statement of Position 98-1 ("SOP 98-1"), "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." This Statement will require us to capitalize approximately \$12 million of costs of internal software development and of third party software purchases that we would have expensed previously. Amortization or depreciation of amounts capitalized will be dependent on the useful lives of the underlying software assets.

We adopted Emerging Issues Task Force Issue No. 97-11 ("EITF 97-11"), "Accounting for Internal Costs Relating to Real Estate Property Acquisitions" upon its issuance in March 1998. EITF 97-11 limits the capitalization of internal real estate acquisition costs to those site-specific costs incurred from the point in time that the real estate acquisition is probable. We consider acquisition of the property probable upon final site approval. EITF 97-11 resulted in approximately \$6 million (\$3 million after-tax) of additional expense in the last three quarters of 1998. Amounts of internal real estate acquisition costs capitalized in 1999 will also be further reduced from their 1998 levels by a discretionary policy change we have adopted to limit the types of costs eligible for capitalization to those direct costs described as capitalizable in SOP 98-1. The combined incremental impact on 1999 results of operations for the application of EITF 97-11 and the policy change is expected to be approximately \$4 million (\$3 million after-tax), almost 50% of which will impact the first quarter.

**DISCRETIONARY METHODOLOGY CHANGES** In 1999, we will refine and enhance our existing actuarial methodology for estimating the self-insured portion of our casualty losses. Our current practice is to increase our independent actuary's ultimate loss projections, which have a 51% confidence level, by a consistent percentage to improve the confidence level of our loss estimates. Confidence level means the likelihood that our actual losses will be equal to or below those estimates. Based on our independent actuary's opinion, our current practice produces a very conservative confidence factor at a higher level than our target of 75%. Our actuary believes our 1999 change will produce estimates at our 75% target confidence level for each self-insured year. We estimate this change in methodology will increase our 1999 results of operations by \$5 million (\$3 million after-tax). The majority of this increase will occur in our first 1999 actuarial evaluation which we currently expect to recognize in the first quarter.

Accounting for pensions requires us to develop an assumed interest rate on securities with which the pension liabilities could be effectively settled. In estimating this discount rate, we look at rates of return on high-quality corporate fixed income securities currently available and expected to be available during the period to the maturity of the pension benefits. As it is impractical to find an investment portfolio which exactly matches the estimated payment stream of the pension benefits, we often have projected short-term cash surpluses. Effective for 1999, we changed our method of determining the pension discount rate to better reflect the assumed investment strategies we would most likely use to invest any short-term cash surpluses. Previously, we assumed that all short-term cash surpluses would be invested in U.S. government securities. Our new methodology assumes that our investment strategies would be equally divided between U.S. government securities and high-quality corporate fixed income securities. The change in methodology is estimated to favorably impact 1999 results of operations by approximately \$6 million (\$4 million after-tax).

**BUSINESS STANDARDIZATION CHANGES** In 1999, we will begin the standardization of our U.S. people policies, which will require changes by certain of our businesses. Most of these changes are not expected to have a significant financial impact. As part of this process, our vacation policies will be conformed to a fiscal-year-based, earn-as-you-go, use-or-lose policy from policies under which employees' vested vacations were attributable to services rendered in prior years. Over the two-year implementation period for this vacation policy change, the reduction of our accrued vacation liabilities could be as much as \$20 million. The total reduction and the portion attributable to 1999 are not determinable at this time, as final decisions regarding specific transition rules including possible vacation buyouts for some of the affected employee groups have not yet been made.

In addition, in 1999, we will focus on standardizing all systems and accounting practices for our U.S. businesses. We currently estimate the results of standardizing our accounting practices will not have a significant impact on our results of operations.

#### STORE PORTFOLIO PERSPECTIVES

Beginning in 1995, we have been working to reduce our share of total system units by selling our restaurants to existing and new franchisees where their expertise can be leveraged to improve our concepts' overall operational performance, while retaining our ownership of key markets. In addition, we also began an aggressive program to close our underperforming stores. Our portfolio-balancing activity has reduced, and will continue to reduce, our reported revenues and increase the importance of system sales as a key performance measure. Refranchising at appropriate prices frees up invested capital while continuing to generate franchise fees, thereby improving returns. The impact of refranchising gains is expected to decrease over time as we approach a Company/franchise balance more consistent with our major competitors. The following table summarizes our refranchising activities over the last four years:

**Our 1998 portfolio ownership is down 6% to 32%.**

	Total	1998	1997	1996	1995
Number of units refranchised	3,730	1,389	1,418	659	264
Refranchising proceeds, pre-tax	\$ 2,074	\$ 784	\$ 770	\$ 355	\$ 165
Refranchising net gain, pre-tax	\$ 623	\$ 279 <sup>(a)</sup>	\$ 112 <sup>(b)</sup>	\$ 139	\$ 93

(a) Includes unfavorable adjustments to our 1997 fourth quarter charge of \$2 million. Excluding the adjustments, refranchising net gain was \$281 million.

(b) Includes a 1997 fourth quarter charge of \$136 million. Excluding the charge, the 1997 refranchising net gain was \$248 million.

The following table summarizes our store closure activities over the last four years:

	Total	1998	1997	1996	1995
Number of units closed	1,941	661	661	352	267
Store closure expense	\$ 299	\$ (27) <sup>(a)</sup>	\$ 248 <sup>(b)</sup>	\$ 40	\$ 38

(a) Includes favorable adjustments to our 1997 fourth quarter charge of \$66 million. Excluding the adjustments, 1998 store closure costs were \$29 million.

(b) Includes a 1997 fourth quarter charge of \$213 million. Excluding the charge, 1997 store closure costs were \$36 million.

Our ownership percentage (including joint venture units) of our Core Businesses' total system units decreased by almost 6 percentage points from year-end 1997 and by 12 percentage points from year-end 1996 to 32% at December 26, 1998. This reduction was a result of our portfolio initiatives and the relative number of new points of distribution added and units closed by our franchisees and licensees and by us.

#### ADDITIONAL FACTORS EXPECTED TO IMPACT 1999 COMPARISONS WITH 1998

Our facility actions net gain was \$221 million (\$129 million after-tax) in 1998 excluding favorable adjustments to our 1997 fourth quarter charge. Facility actions net loss (gain) includes refranchising gains or losses, costs of closing underperforming stores and impairment charges for restaurants we intend to continue to use in the business or to close in a future quarter. Facility actions net gain in 1999 is expected to be half the level of the net gain recognized in 1998. However, if market conditions are favorable, we expect to sell more than the 800-900 units we have currently forecasted which would impact the amount of our net gain for 1999.

We are phasing in certain structural changes to our Executive Income Deferral Program ("EID") during 1999 and 2000 which are further discussed in Note 14 to the Consolidated Financial Statements. One such 1999 change requires all subsequent payouts under the EID to be made only in our Common Stock rather than cash or Common Stock at our option. This restriction applies only if the participant's original deferrals were invested in discounted phantom shares of our Common Stock. Previously for accounting purposes, we were required to assume the payment was made in cash. In 1999, we will no longer expense the appreciation, if any, attributable to the investments in these phantom shares. If this change had been in effect from the beginning of 1998, general and administrative expenses would have been approximately \$10 million (\$6 million after-tax) lower than reported. The 1999 impact of the change is dependent on movements in the market price of our Common Stock and the effect of forfeitures, if any, and cannot currently be estimated.

In 1999, we expect to incur approximately \$5 million (\$3 million after-tax) of additional charges related to our unusual charge for our 1998 strategic decision to streamline our international businesses. In 1999, we also expect to incur approximately \$3 million (\$2 million after-tax) of expenses related to the start-up of a

unified food service purchasing cooperative and costs associated with reducing the workforce in our internal purchasing function. In 1998, we incurred \$2 million (\$1 million after-tax) related to the start-up of the co-op.

In 1998, we completed our relocation of our Wichita, Kansas operations to other facilities. The total cost we incurred in 1998 of \$14 million (\$9 million after-tax) included termination benefits, relocation costs, early retirement and other expenses related to this relocation. Due to contractual disputes with the proposed buyer, the expected fourth quarter 1998 sale of the facility at a gain to this buyer did not occur and is not considered imminent. We continue to expect to sell the facility at a price which should at least recover its carrying amount, but cannot estimate either the amount or timing of any potential gain at this time.

Certain cost recovery agreements with Ameriserve and PepsiCo reduced our 1998 general, administrative and other ("G&A") costs by approximately \$8 million (\$5 million after-tax). These agreements were terminated during 1998.

## Results of Operations

Our Spin-off in 1997, our 1997 fourth quarter charge, the impacts of the disposal of our Non-core Businesses and fluctuations in the number and amount of gains related to refranchised stores represent significant items which complicate year-over-year comparisons.

Prior to October 7, 1997, our historical financial statements were impacted by our lack of history as an independent, publicly owned company. The amounts for certain items, specifically general and administrative expenses, interest expense and income taxes, included in our historical reported results for periods prior to the Spin-off, include allocations or computations which are not indicative of the amounts we would have incurred if we had been an independent, publicly owned company during all periods presented. See Note 2 to the Consolidated Financial Statements.

Additionally, comparative information is impacted by the operations of and disposal charges related to our Non-core Businesses in 1997. These disposal charges included an estimated provision for all expected future liabilities associated with the disposal of our Non-core Businesses. We were required to retain these liabilities as part of the Spin-off. Our best estimates of all such liabilities have been included in the accompanying Consolidated

Financial Statements. See Note 19 to the Consolidated Financial Statements. Actual amounts incurred may ultimately differ from these estimates. However, we believe the amounts, if any, in excess of our previously recorded liabilities are not likely to have a material adverse effect on our results of operations, financial condition or cash flow.

Following is a summary of the results of the operations and disposal of our Non-core Businesses:

	1997	1996
Revenues	\$ 268	\$ 394
% of total revenues	3%	4%
Non-core Businesses		
operating profit (loss),		
before disposal charges	\$ 13	\$ (10)
Unusual disposal charges	54	246
Net loss	(26)	(200)

Worldwide restaurant margin grew by almost 2 points!



## Worldwide Results of Operations

	1998		1997		% B(W) vs. 1996 <sup>(2)</sup>
	Total	% B(W) vs. 1997	Total	Adjusted <sup>(1)</sup>	
SYSTEM SALES — CORE BUSINESSES ONLY	\$ 20,620	1	\$ 20,465		1
REVENUES					
Company sales	\$ 7,852	(14)	\$ 9,112		(6)
Franchise and license fees <sup>(3)</sup>	616	7	573		16
Total Revenues	\$ 8,468	(13)	\$ 9,685		(5)
COMPANY RESTAURANT MARGIN					
U.S.	\$ 819	—	\$ 816		4
International	239	(1)	242		2
Total	\$ 1,058	—	\$ 1,058		4
% of sales	13.5%	1.9 pts.	11.6%		1.1 pts.
OPERATING PROFIT					
Ongoing operating profit	\$ 768	14	\$ 672	\$ 672	16
Facility actions net gain (loss)	275	NM	(247)	163	NM
Unusual charges	(15)	NM	(184)	(64)	NM
Operating profit	1,028	NM	241	771	NM
INTEREST & INCOME TAXES					
Interest expense, net	272	1	276	276	8
Income tax provision	311	NM	76	181	45
NET INCOME (LOSS)	\$ 445	NM	\$ (111)	\$ 314	NM
Earnings per diluted share	\$ 2.84				
Pro forma loss per basic share <sup>(4)</sup>			\$ (0.73)		
Pro forma earnings per diluted share <sup>(5)</sup>				\$ 2.01	

(1) Excludes the effects of the 1997 fourth quarter charge.

(2) Computed based on adjusted amounts, if applicable.

(3) Excluding the special 1997 KFC renewal fees, 1998 and 1997 increased 12% and 11% over prior year, respectively.

(4) The shares used to compute pro forma loss per basic share for the 52 weeks ending December 27, 1997 assumes the 152 million shares of TRACON Common Stock issued on October 7, 1997 had been outstanding for the entire year.

(5) The shares used to compute pro forma earnings per diluted share for 1997 are the same as those used in 1998, as our capital structure as an independent, publicly owned company did not exist until October 7, 1997.

## Worldwide Restaurant Unit Activity

	Company	Joint Venture	Franchised	Licensed	Total
Balance at Dec. 28, 1996	11,876	1,007	13,066	3,147	29,096
New Builds & Acquisitions	280	123	972	731	2,106
Refranchising & Licensing	(1,407)	(11)	1,410	8	—
Closures	(632)	(29)	(351)	(478)	(1,490)
Balance at Dec. 27, 1997	10,117	1,090	15,097	3,408	29,712
New Builds & Acquisitions	266	94	909	550	1,819
Refranchising & Licensing	(1,380)	(9)	1,309	80	—
Closures	(606)	(55)	(665)	(442)	(1,768)
Balance at Dec. 26, 1998	8,397 <sup>(a)</sup>	1,120 <sup>(a)</sup>	16,650	3,596	29,763

(a) Includes 185 Company and 4 Joint Venture units approved for closure but not yet closed at December 26, 1998, of which 123 were included in our 1997 fourth quarter charge.

**SYSTEM SALES** increased \$155 million or 1% in 1998. Excluding the negative impact of foreign currency translation, system sales increased by \$871 million or 4%. The increase reflected the development of new units, primarily by franchisees and licensees and positive same store sales growth. U.S. development was primarily at Taco Bell and international development was primarily in Asia. This growth in system sales was partially offset by store closures.

System sales increased \$185 million or 1% in 1997. Excluding the negative impact of foreign currency translation, system sales increased \$525 million or 3%. New unit growth by franchisees and licensees as well as new Company units, primarily in international markets, was partially offset by store closures.

**REVENUES** decreased \$1.2 billion or 13% in 1998. Company sales decreased \$1.3 billion or 14%. Included in 1997 revenues were the Non-core Businesses' revenues of \$268 million. Excluding the negative impact of foreign currency translation and revenues from the Non-core Businesses, revenues decreased \$755 million or 8% and Company sales decreased \$821 million or 9%. The decrease in Company sales was primarily due to the portfolio effect partially offset by new unit development and effective net pricing. Franchise and license fees increased \$43 million or 7% in 1998. Excluding the negative impact of foreign currency translation and the special 1997 KFC renewal fees of \$24 million, franchise and license fees increased \$89 million or 16%. The increase was primarily driven by units acquired from us and new unit development primarily in Asia and at Taco Bell in the U.S., partially offset by store closures by franchisees and licensees.

Revenues decreased \$547 million or 5% in 1997. Company sales decreased \$626 million or 6% in 1997. The Non-core Businesses contributed \$268 million and \$394 million in 1997 and 1996, respectively. Excluding the negative impact of foreign currency translation, revenues decreased \$465 million or 5% and Company sales decreased \$555 million or 6%. The decrease in Company sales was primarily due to the portfolio effects partially offset by higher effective net pricing. Franchise and license fees increased \$79 million or 16% in 1997. Excluding the negative impact of foreign currency translation and the special 1997 KFC renewal fees of \$24 million, franchise and license fees increased \$65 million or 13%. The increase was primarily driven by new unit development and units acquired from us, partially offset by store closures by franchisees and licensees.

## Restaurant Margin - Worldwide

	1998	1997	1996
Company sales	100.0%	100.0%	100.0%
Food and paper	32.1	32.4	33.0
Payroll and employee benefits	28.6	28.7	28.7
Occupancy and other operating expenses	25.8	27.3	27.8
Restaurant margin	13.5%	11.6%	10.5%

Our restaurant margin as a percent of sales increased almost 190 basis points for 1998. Portfolio effect contributed approximately 65 basis points and the suspension of depreciation and amortization relating to our 1997 fourth quarter charge contributed approximately 55 basis points to our improvement. Excluding the portfolio effect and the benefits of the fourth quarter charge, our restaurant margin increased approximately 70 basis points. The improvement was largely due to effective net pricing in excess of increased costs, primarily labor. Labor increases were driven by higher wage rates, primarily the September 1997 minimum wage increase, an increase in the management complement in our Taco Bell restaurants and lower favorable insurance-related adjustments in 1998. The decrease in occupancy and other operating expenses related primarily to higher spending in 1997 on improving store condition and quality initiatives at Taco Bell and Pizza Hut as well as an increase in higher favorable insurance-related adjustments in 1998. These favorable items were partially offset by increased store refurbishment expenses at KFC in 1998.

Our restaurant margin as a percent of sales increased approximately 110 basis points for 1997. The increase in restaurant margin in 1997 was partially driven by effective net pricing in excess of increased costs, primarily labor. Portfolio effect contributed approximately 55 basis points and the Non-core Businesses contributed approximately 20 basis points of our improvement. In 1997, we also benefited from lower commodity costs primarily related to favorable cheese and chicken prices. This margin increase was partially offset by lower volumes.

## General, Administrative and Other Expenses

	1998	% B(W) vs. 1997	1997	% B(W) vs. 1996
G&A — Core	\$ 930	—	\$ 927	(3)
G&A — Non-core	—	NM	24	37
Equity income from investments in unconsolidated affiliates	(18)	NM	(8)	4
Foreign exchange (gains) losses	(6)	NM	16	NM
	<u>\$ 906</u>	<u>6</u>	<u>\$ 959</u>	<u>(3)</u>

Our core G&A increased \$3 million in 1998. The increase reflected higher investment spending offset by the favorable impacts of stores sold or closed, decreased restaurant support center and field operating overhead and foreign currency translation. Our investment spending consisted primarily of costs related to spending on Year 2000 compliance and remediation efforts of \$31 million in 1998 versus \$4 million in 1997, along with the costs to relocate our processing center from Wichita to other existing restaurant support centers of \$14 million. In addition, we experienced increased administrative expenses as an independent, publicly owned company and incurred additional expenses related to continuing efforts to improve and standardize administrative and accounting systems.

Included in our 1997 and 1996 core G&A were PepsiCo allocations of \$37 million and \$53 million, respectively, reflecting a portion of PepsiCo's shared administrative expenses prior to the Spin-off. The allocated PepsiCo administrative expenses were based on PepsiCo's total corporate administrative expenses using a ratio of our revenues to PepsiCo's revenues. We believe this basis of allocation was reasonable based on the facts available at the date of such allocation.

However, our ongoing G&A as an independent, publicly owned company in 1998 exceeded the annualized amount of the 1997 PepsiCo allocation by approximately \$30 million. The 1998 increase was partially offset by the absence of non-recurring TRICON start-up costs of approximately \$14 million which were incurred in 1997. The 1998 increased expenses were higher than the \$20 million we estimated in our 1997 Annual Report on Form 10-K, primarily due to increased incentive and stock-based compensation. These increased compensation costs are due to better-than-expected operating results, as well as strong growth in the market value of our Common Stock for the second half of 1998, partially offset by delays in staffing positions at TRICON.

Equity income from investments in our unconsolidated affiliates increased \$10 million in 1998. This increase was due primarily to lower amortization relating to the impact of the joint venture investment impairment included in our 1997 fourth quarter charge and, to a lesser extent, the impact of new unit development primarily by our joint venture in the United Kingdom. Net foreign exchange gains were \$6 million in 1998 compared to net foreign exchange losses of \$16 million in 1997. This improvement was due primarily to non-recurring 1997 foreign exchange losses, predominantly in Thailand and the Netherlands, and to foreign exchange gains in 1998 primarily due to U.S. dollar denominated short-term investments in Canada.

Our core G&A increased \$30 million or 3% in 1997 reflecting increased investment spending, TRICON start-up costs, higher incentive compensation and increased litigation-related costs. Investment spending consisted primarily of costs related to improving and updating administrative systems, including initial spending of \$4 million on Year 2000 compliance and remediation efforts, as well as investments in certain key international markets. These higher expenses were partially offset by the lapping of a reorganization charge for Pizza Hut in 1996, overall lower project spending and field overhead, particularly at Pizza Hut, and the favorable impacts of stores sold or closed.

## Facility Actions Net (Gain) Loss

	1998		1997		1996
	Total	Excluding 1997 4th Qtr. Charge Adjustments	Total	Excluding 2nd Qtr. Charge	
Refanchising gains, net	\$ (279)	\$ (281)	\$ (112)	\$ (248)	\$ (139)
Store closure costs	(27)	29	248	35	40
Impairment charges	31	31	111	50	62
Facility actions net (gain) loss	<u>\$ (275)</u>	<u>\$ (221)</u>	<u>\$ 247</u>	<u>\$ (163)</u>	<u>\$ (37)</u>

Refranchising gains, which included initial franchise fees of \$44 million, \$41 million and \$22 million in 1998, 1997 and 1996, respectively, as well as a \$100 million tax-free gain from refranchising our restaurants in New Zealand through an initial public offering in 1997, resulted from the refranchising of 1,389 units in 1998, 1,418 units in 1997 and 659 units in 1996.

Prior to April 23, 1998, we provided store closure costs when we made the decision to close a unit. At that time, in response to the Securities and Exchange Commission's ("SEC") interpretation of Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" ("SFAS 121"), we changed our store closure accounting policy. For closure decisions made subsequent to April 23, 1998, we only recognize any required asset impairment as a component of store closure costs when we have closed the restaurant within the same quarter the closure decision is made. The impact of this change reduced 1998 store closure costs by \$4 million which was more than offset by increased impairment described in next paragraph. We closed 661 units in both 1998 and 1997, and 352 units in 1996.

Impairment charges were \$31 million in 1998. Prior to April 23, 1998, our impairment charges resulted from our normal semi-annual evaluation of stores which we will continue to use in the business. Stores that meet our "two-year history of operating losses," our primary impairment indicator, or which we believe may be impaired due to other changes or circumstances are evaluated for impairment. In 1998, upon adoption of the SEC's interpretation of SFAS 121, we also perform impairment evaluations when we expect to actually close a store beyond the quarter in which our closure decision is made. This change resulted in additional impairment charges of \$6 million in 1998. We believe the overall decrease in impairment in 1998 was significantly impacted by 1997 decisions included in our fourth quarter charge to dispose of certain stores which may have otherwise been impaired in our evaluations, and improved performance primarily at Pizza Hut in the U.S. Impairment charges of \$50 million in 1997 and \$62 million in 1996 resulted from our semi-annual impairment evaluations of restaurants.

## Operating Profits

	% B(W)		% B(W)	
	1998	vs. 1997	1997	vs. 1996
U.S. — Core	\$ 740	26	\$ 590	14
U.S. — Non-core	—	NM	13	NM
International	191	11	172	15
Foreign exchange gains (losses)	6	NM	(16)	NM
Unallocated and corporate expenses	(169)	(93)	(87)	(20)
Ongoing operating profit	768	14	672	16
Facility actions not gain (loss)	275	NM	(247)	NM
Unusual charges	(15)	NM	(184)	NM
Reported operating profit	\$ 1,028	NM	\$ 241	NM

Ongoing operating profits increased \$96 million or 14% in 1998. Excluding the negative impact of foreign currency translation, ongoing operating profits increased \$120 million or 18%. The increase was driven by higher franchise fees and reduced G&A, partially offset by the absence in 1998 of the Non-core Businesses' operating profit of \$13 million and the special 1997 KFC renewal fees of \$24 million. Ongoing operating profits in 1998 included benefits from our 1997 fourth quarter charge of approximately \$64 million of which \$33 million related to the suspension of depreciation and amortization for stores included in the charge. The benefits from our 1997 fourth quarter charge were almost completely offset by incremental 1998 Year 2000 spending of \$27 million and the decline in Asia profits of \$27 million in 1998 compared to 1997.

Unallocated and corporate expenses increased \$82 million or 93% in 1998. The increase was primarily due to spending on Year 2000 compliance and remediation efforts, costs to relocate our processing center from Wichita to other facilities and expenses incurred as an independent, publicly owned company, as well as, additional expenses related to the efforts to improve and standardize operating, administrative and accounting systems.

Ongoing operating profits increased \$91 million or 16% in 1997. Excluding the negative impact of foreign currency translation, ongoing operating profits increased \$97 million or 17%. The increase relates primarily to increased franchise fees driven by the special 1997 KFC renewal fees of \$24 million and improved restaurant margin, partially offset by an increase in unallocated and corporate expenses. The increase was driven primarily by increased investment spending related to improving and updating administrative systems including initial spending on Year 2000 compliance and remediation efforts, TRICON start-up costs and higher incentive compensation.



## Interest Expense, Net

	1998	1997	1996
External debt	\$ 291	\$ 102	\$ 35
PepsiCo allocation	—	188	275
Interest expense	291	290	310
Interest income	(19)	(14)	(10)
Interest expense, net	\$ 272	\$ 276	\$ 300

Prior to the Spin-off, our operations were financed through operating cash flows, proceeds from refranchising activities and investment by and advances from PepsiCo. At the Spin-off date, we borrowed \$4.55 billion under a bank credit agreement to replace the financing previously provided by PepsiCo and, additionally, to fund a dividend to PepsiCo. See Notes 2 and 9 to the Consolidated Financial Statements. For periods prior to the Spin-off, our interest expense included PepsiCo's allocation of its interest expense (PepsiCo's weighted average interest rate applied to the average balance of investments by and advances from PepsiCo) and interest on our external debt, including capital leases. We believe such allocated interest expense is not indicative of the interest expense that we would have incurred as an independent, publicly owned company or will incur in future periods. Subsequent to the Spin-off date, our interest costs consist primarily of interest expense related to our bank credit agreement, Unsecured Notes and other external debt. Most of the other external debt existed at the Spin-off date.

Our net interest expense decreased approximately \$4 million in 1998. The decline was due to an increase in interest income, partially offset by a slight increase in interest expense. The increase in interest income was driven by higher average international investment balances. The slight increase in interest expense was primarily due to higher average outstanding debt balances.

Interest expense decreased in 1997 primarily due to the lower outstanding amount of PepsiCo-provided financing. This impact was partially offset by the higher interest rate on our bank credit agreement, as compared to the PepsiCo rate used in the allocation process, and also higher outstanding debt levels.

## Income Taxes

	1998	1997	1996
Income taxes	\$ 311	\$ 76	\$ 125
Effective tax rate	41.1%	NM	NM
Ongoing*			
Income taxes	\$ 302	\$ 211	\$ 183
Effective tax rate	42.1%	45.9%	57.5%

\* Adjusted to exclude the effects of the following: (1) the 1997 fourth quarter charge adjustments and unusual charges in 1998; (2) the 1997 New Zealand IPO \$100 million tax loss gain; the 1997 fourth quarter charge and the remaining portion of the 1997 unusual charges in 1998; and (3) the unusual disposal charges related to the Non-core Businesses in 1998.

For periods prior to the Spin-off in 1997, income tax expense was calculated, to the extent possible, as if we filed income tax returns separate from PepsiCo. As PepsiCo managed its tax position on a consolidated basis, which takes into account the results of all its businesses, our effective tax rate in the future could vary significantly from historical effective tax rates calculated for periods prior to the Spin-off.

The following reconciles the U.S. Federal statutory tax rate to our ongoing effective rate:

	1998	1997	1996
U.S. Federal statutory tax rate	35.0%	35.0%	35.0%
State income tax, net of Federal tax benefit	4.4	4.4	2.2
Foreign and U.S. tax effects attributable to foreign operations	4.4	5.3	17.0
Favorable adjustments relating to prior years	(4.5)	(0.7)	(0.3)
Other, net	2.8	1.9	3.6
Ongoing effective tax rate	42.1%	45.9%	57.5%

The 1998 ongoing effective tax rate decreased 3.8 points to 42.1%. The decrease in the 1998 ongoing effective tax rate was primarily due to favorable adjustments related to prior years.

The 1997 ongoing effective tax rate decreased 11.6 points to 45.9%. The decrease in the 1997 ongoing effective tax rate was primarily due to the decrease in taxes attributable to foreign operations, partially offset by an increase in state taxes. The foreign decrease was due to the absence of the adjustment recorded in 1996 to establish a valuation allowance. The increase in state tax was primarily due to an increase in the provision related to prior tax years.

The effective tax rate attributable to foreign operations varied from year-to-year but in each year was higher than the U.S. Federal statutory tax rate. This was primarily due to foreign tax rate differentials, including foreign withholding tax paid without benefit of the related foreign tax credit for U.S. income tax purposes and losses of foreign operations for which no tax benefit could be currently recognized.



## Earnings (Loss) Per Share

The components of earnings (loss) per common share were as follows:

	Diluted <sup>(a)</sup> 1998	Basic 1998	Pro-Forma Basic <sup>(f)</sup>	
			1997	1996
Operating earnings				
— Core	\$ 1.83	\$ 1.88	\$ 1.37	\$ 0.83
Operating earnings (loss) — Non-core	—	—	0.05	(0.08)
Facility actions				
net gain (loss) <sup>(d)</sup>	1.03	1.06	(1.07)	0.14
Unusual charges —				
Core <sup>(e)</sup>	(0.02)	(0.02)	(0.86)	—
Unusual charges —				
Non-core	—	—	(0.22)	(1.24)
Total	\$ 2.84	\$ 2.92	\$ (0.73)	\$ (0.35)

(a) Based on 156 million shares applicable to diluted earnings. See Note 3 to the Consolidated Financial Statements.

(b) The shares used to compute pro forma basic loss per common share for the 52 weeks ending December 27, 1997 and December 28, 1996 assumes the 152 million shares of TRIOH Common Stock issued on October 7, 1997 had been outstanding for all periods presented. The dilutive effect of any options has been excluded because we incurred net losses.

(c) 1998 includes favorable adjustments to our 1997 fourth quarter charge of \$0.21 per diluted share. 1997 includes a loss of \$1.60 per basic share included in our total fourth quarter charge of \$2.80 per basic share.

(d) 1998 includes favorable adjustments to our 1997 fourth quarter charge of \$0.04 per diluted share. 1997 includes a loss of \$0.52 per basic share included in our total fourth quarter charge of \$2.00 per basic share.

## U.S. Results of Operations

	1998		1997	
	Amount	% B(W) vs. 1997	Amount	% B(W) vs. 1996
SYSTEM SALES —				
CORE BUSINESSES ONLY	\$ 14,013	4	\$ 13,502	1
REVENUES				
Company sales	\$ 6,013	(14)	\$ 6,994	(8)
Franchise and license fees <sup>(1)</sup>	415	12	371	20
Total Revenues	\$ 6,428	(13)	\$ 7,365	(7)
COMPANY RESTAURANT MARGIN	\$ 819	—	\$ 816	4
% of sales	13.6%	1.9 pts.	11.7%	1.4 pts.
OPERATING PROFIT <sup>(2)</sup>				
Core Businesses	\$ 740	26	\$ 590	14
Non-core Businesses	—	NM	13	NM
	\$ 740	23	\$ 603	19

(1) Excluding the special 1997 KFC renewal fees, 1998 and 1997 increased 12% and 13% over prior year, respectively.

(2) Excludes facility actions net gain (loss) and unusual charges.

## U.S. Restaurant Unit Activity

We've taken aggressive portfolio actions.

	Company	Franchised	Licensed	Total
Balance at Dec. 28, 1996	9,396	8,237	2,903	20,536
New Builds & Acquisitions	141	324	731	1,196
Refranchising & Licensing	(1,199)	1,191	8	—
Closures	(516)	(155)	(475)	(1,146)
Balance at Dec. 27, 1997	7,822	9,597	3,167	20,586
New Builds & Acquisitions	77	342	508	927
Refranchising & Licensing	(1,249)	1,246	3	—
Closures	(418)	(209)	(403)	(1,030)
Balance at Dec. 26, 1998	6,232 <sup>(a)</sup>	10,976	3,275	20,483

(a) Includes 151 Company units approved for closure, but not yet closed at December 26, 1998, of which 109 units were included in our 1997 fourth quarter charge.

**SYSTEM SALES** increased \$511 million or 4% in 1998. The increase was attributable to new unit development, primarily by franchisees and licensees of Taco Bell and, to a lesser extent, KFC, and positive same store sales growth at all three of our brands. These increases were partially offset by the impact of store closures.

The 1997 increase of \$114 million or 1% in system sales was primarily due to new unit development, principally by franchisees and licensees at Taco Bell. This increase was partially offset by the impact of store closures.

**REVENUES** decreased \$937 million or 13% primarily due to our decline in Company sales of \$981 million or 14% in 1998. Excluding the effect of the Non-core Businesses, our Company sales decreased \$715 million or 11%. The decline in Company sales was driven by the portfolio effect partially offset by positive same store sales growth at all three of our brands.

We measure same store sales only for our U.S. Company units. Same store sales at Pizza Hut increased 6% in 1998. The increase reflects a higher check average at traditional and delivery units driven by the new product offerings of "The Edge" and the "Sicilian" pizzas as well as the promotion of the "Stuffed Crust" Pizza. The increase was partially offset by volume declines. KFC's same store sales increased 3% in 1998. The improvement was primarily driven by favorable effective net pricing and strong product promotions including "Popcorn Chicken," "Honey Barbecue" wings and "Original Recipe." Same store sales for Taco Bell increased 3% in 1998. The increase was driven by an increase in average guest check resulting primarily from favorable effective net pricing. Same store sales also benefited from the introduction of "Gorditas," a higher priced menu item. The increase was partially offset by volume declines.

Franchise and license fees increased \$44 million or 12% in 1998. Excluding the special 1997 KFC renewal fees (described below), 1998 franchise and license fees increased \$68 million or 19%. The increase was primarily driven by units acquired from us and new unit development, partially offset by the impact of store closures by franchisees and licensees.

Revenues decreased \$558 million or 7% in 1997 primarily due to Company sales decreases of \$621 million or 8%. Excluding the impact of the Non-core Businesses, Company sales decreased \$496 million or 7%. The decrease was driven primarily by the portfolio effect. The decline was partially offset by higher overall effective net pricing. This pricing impact occurred primarily at Taco Bell, which more than offset the impact of lower prices at Pizza Hut.

Same store sales at KFC increased 2% in 1997 driven by product promotions, favorable effective net pricing and increased delivery sales, partially offset by lower transaction counts. Same store sales at Pizza Hut decreased 1% for 1997, rebounding from a 7% decline through the second quarter. At Pizza Hut, lower average guest checks in 1997 and decreasing transaction counts in the first half of the year were partially offset in the second half by quality initiatives, increasing transaction counts and the introduction of "The Edge" Pizza. Taco Bell same store sales increased 2% in 1997 reflecting the successful Star Wars and Batman promotions, favorable product mix shifts and pricing, offset by lower transaction counts.

Franchise and license fees increased \$63 million or 20% in 1997. In 1997, we generated \$24 million of special KFC renewal fees. Substantially all of KFC's franchisees renewed their franchise agreements, typically for 20 years, during 1997. As part of this special renewal program at KFC, certain participating franchisees also committed to attain over the next several years certain facility standards based on physical assessment of that franchisee's restaurants. We believe these upgrades of the franchised facilities will ultimately result in higher system sales and, therefore, higher franchise fees. Excluding the special 1997 KFC renewal fees, our franchise and license fees increased \$39 million or 13% in 1997. The increase was primarily driven by units acquired from us and new unit development, partially offset by store closures by franchisees and licensees.



## Restaurant Margin - U.S.

	1998	1997	1996
Company sales	100.0%	100.0%	100.0%
Food and paper	31.0	31.1	32.1
Payroll and employee benefits	30.4	30.5	30.2
Occupancy and other operating expenses	25.0	26.7	27.4
Restaurant margin	13.6%	11.7%	10.3%

Our restaurant margin as a percentage of sales increased over 190 basis points in 1998. Portfolio effect contributed approximately 75 basis points and the suspension of depreciation and amortization relating to our fourth quarter charge contributed approximately 40 basis points. Excluding the portfolio effect and the benefit of the fourth quarter charge, our restaurant margin increased approximately 80 basis points. In 1998, we benefited from favorable effective net pricing in excess of costs, primarily labor and commodity costs. Our labor increases were driven by higher wage rates, primarily the September 1997 minimum wage increase, an increase in the management complement at our Taco Bell restaurants and lower favorable insurance-related adjustments in 1998. Commodity cost increases, primarily cheese and produce, were partially offset by a decrease in other commodity costs. Our occupancy and other operating expenses were favorably impacted by higher favorable insurance-related adjustments in 1998 and the decreased store condition and quality initiative spending at Pizza Hut and Taco Bell. These favorable items were partially offset by increased store refurbishment expenses at KFC in 1998.

Our increase in restaurant margin of almost 140 basis points in 1997 was driven almost equally by effective net pricing in excess of increased costs, primarily labor, and the portfolio effect. This improvement was partially offset by the effect of reduced transaction counts. The higher labor costs were due to the increased minimum wage and to costs incurred to improve customer satisfaction, partially offset by favorable actuarial adjustments to workers' compensation liabilities. In 1997, we also benefited from lower commodity costs, primarily related to favorable cheese and chicken prices, and the disposal of the Non-core Businesses.

**OPERATING PROFITS** from our Core Businesses, excluding facility actions net gain and unusual charges, increased \$150 million or 26% in 1998. The increase was driven by reduced G&A expenses, higher franchise and license fees and restaurant margin improvement partially offset by the absence of the special 1997 KFC renewal fees. The decline in G&A was primarily due to the portfolio effect and a decrease in restaurant support center and field operating overhead costs. Operating profits included the benefits related to our 1997 fourth quarter charge of approximately \$35 million, of which \$19 million related to the suspension of depreciation and amortization for the stores included in the charge.

Operating profits from our Core Businesses, excluding facility actions net gain and unusual charges increased \$74 million or 14% in 1997. The increase was primarily due to higher continuing franchise and license fees, the special 1997 KFC renewal fees and improved restaurant margin. The increases were partially offset by an increase in G&A and other expenses.

## International Results of Operations

	1998		1997	
	Amount	% B/W vs. 1997	Amount	% B/W vs. 1996
SYSTEM SALES	\$ 6,607	(5)	\$ 6,963	1
REVENUES				
Company sales	\$ 1,839	(13)	\$ 2,118	—
Franchise and license fees	201	—	202	9
Total Revenues	\$ 2,040	(12)	\$ 2,320	—
COMPANY				
RESTAURANT				
MARGIN	\$ 239	(1)	\$ 242	2
% of sales	13.0%	1.6 pts.	11.4%	.2 pts.
OPERATING PROFIT <sup>(1)</sup>	\$ 191	11	\$ 172	11

(1) Excludes facility actions net gain (loss) and unusual charges.



## International Restaurant Unit Activity

	Company	Joint Venture	Franchised	Licensed	Total
Balance at Dec. 28, 1996	2,480	1,007	4,829	244	8,560
New Builds & Acquisitions	139	123	648	—	910
Refanchising & Licensing	(208)	(11)	219	—	—
Closures	(116)	(29)	(196)	(3)	(344)
Balance at Dec. 27, 1997	2,295	1,090	5,500	241	9,126
New Builds & Acquisitions	189	94	567	42	892
Refanchising & Licensing	(131)	(9)	63	77	—
Closures	(188)	(55)	(456)	(39)	(738)
Balance at Dec. 26, 1998	2,165 <sup>(a)</sup>	1,120 <sup>(a)</sup>	5,674	321	9,280

(a) Includes 15 Company and 4 Joint Venture units approved for closure, but not yet closed at December 26, 1998, of which 14 units were included in our 1997 fourth quarter charge.

**SYSTEM SALES** decreased \$356 million or 5% in 1998. Excluding the negative impact of foreign currency translation, system sales increased \$360 million or 5%. The increase was driven by new unit development, primarily in Asia, partially offset by store closures in other countries/markets.

System sales increased \$71 million or 1% in 1997. Excluding the negative impact of foreign currency translation, system sales increased \$411 million or 6% in 1997. This growth was driven by new unit development, partially offset by store closures. Franchisee activity drove system unit development with approximately 50% of that activity occurring in Asia.

**REVENUES** decreased \$280 million or 12% in 1998. Excluding the negative impact of foreign currency translation, revenues decreased \$86 million or 4%. Company sales decreased \$279 million or 13% in 1998. Excluding the negative impact of foreign currency translation, Company sales decreased \$107 million or 5%. The decrease in 1998 was driven by the portfolio effect,

partially offset by new unit development and effective net pricing. Franchise and license fees decreased \$1 million or less than 1%. Excluding the negative impact of foreign currency translation, franchise and license fees increased \$21 million or 11%. The increase was primarily driven by new unit development and units acquired from us, partially offset by store closures by franchisees and licensees.

Revenues increased \$12 million or less than 1% in 1997. Excluding the negative impact of foreign currency translation, revenues increased \$93 million or 4%. This increase relates primarily to higher effective net pricing, new unit development in Asia and an increase in franchise fees attributable to development, partially offset by store closures. Company sales in 1997 decreased \$5 million or less than 1%. Excluding the negative impact of foreign currency translation, Company sales increased \$66 million or 3%. This increase was driven primarily by higher effective net pricing and unit development, partially offset by the

effect of refranchising our restaurants in New Zealand through an initial public offering in the second quarter. Franchise and license fees increased \$17 million or 9% in 1997 primarily driven by new unit development and units acquired from us, partially offset by store closures by franchisees and licensees.

## Restaurant Margin - International

	1998	1997	1996
Company sales	100.0%	100.0%	100.0%
Food and paper	35.8	36.5	36.3
Payroll and employee benefits	22.6	22.7	23.2
Occupancy and other operating expenses	28.6	29.4	29.3
Restaurant margin	13.0%	11.4%	11.2%

Our restaurant margin increased over 160 basis points in 1998. Excluding the negative impact of foreign currency translation, restaurant margin increased approximately 195 basis points. The increase was driven primarily by the suspension of depreciation and amortization relating to restaurants included in our 1997 fourth quarter charge, which contributed 110 basis points. The portfolio effect also contributed approximately 30 basis points to the improvement. The remaining margin improvement of approximately 55 basis points resulted from favorable effective net pricing in excess of costs in Mexico, Australia and Spain. Restaurant margin improvement was partially offset by volume declines in Asia, led by Korea. The economic turmoil throughout Asia resulted in an overall volume decline, even though we had volume increases in Mexico, Canada and Spain.

Our restaurant margin increased over 20 basis points in 1997. The increase was driven by effective net pricing in excess of cost increases, primarily labor, offset by volume declines. Foreign currency translation and the portfolio effect did not have a significant impact.

**OPERATING PROFITS,** excluding facility actions net gain and unusual charges, increased \$19 million or 11% in 1998. Excluding the negative impact of foreign currency translation, operating profits increased \$43 million or 25% in 1998. The increase was driven by an increase in franchise fees and a decline in G&A. Operating profits included benefits related to our 1997 fourth quarter charge of approximately \$29 million, of which \$14 million related to the suspension of depreciation and amortization for the stores included in the charge. These benefits were fully offset by the decline in Asia operating profits and Year 2000 spending.

Operating profits, excluding the fourth quarter charge, other facility actions and unusual charges, increased \$17 million or 11% in 1997. Excluding the negative impact of foreign currency translation, operating profits increased \$23 million or 15%. The increase in 1997 was driven by higher franchise fees, new unit development and higher restaurant margin dollars. These increases were partially offset by an increase in G&A.

## Consolidated Cash Flows

	1998	1997	1996
Net cash provided by operating activities	\$ 674	\$ 810	\$ 713
Refranchising of restaurants	784	770	355
	<b>\$ 1,458</b>	<b>\$ 1,580</b>	<b>\$ 1,068</b>
Capital spending	\$ 460	\$ 541	\$ 620

**NET CASH PROVIDED BY OPERATING ACTIVITIES** decreased \$136 million or 17% to \$674 million in 1998. Cash used for working capital was \$106 million for 1998 compared to cash provided by working capital of \$27 million in 1997. The 1998 use was primarily due to an increase in current deferred tax assets and reduced income taxes payable. Excluding net changes in working capital, net income before facility actions and all other non-cash charges was essentially unchanged despite the decline in the number of our restaurants in the current year relating to our portfolio activities.

Net cash provided by operating activities in 1997 increased \$97 million or 14% to \$810 million. This was driven by an increase in net income prior to facility actions net loss and unusual charges recorded in 1997 and an increase in our normal working capital deficit primarily related to higher income tax payables. These increases were partially offset by reduced depreciation and amortization in 1997. The decrease in depreciation and amortization related to refranchisings, store closures and impairment charges.

**NET CASH PROVIDED BY INVESTING ACTIVITIES** decreased \$164 million to \$302 million in 1998 compared to \$466 million in 1997. The 1998 decrease was primarily due to the prior year sale of the Non-core Businesses offset by increased proceeds from refranchising and the sales of property, plant and equipment. Capital spending decreased by \$81 million or 15%.

The 1997 increase of \$715 million was primarily attributable to an increase in proceeds from refranchising of restaurants of \$415 million over 1996 and the proceeds from the sale of the Non-core Businesses of \$186 million. Capital spending in 1997 decreased by \$79 million or 13%.

**NET CASH USED FOR FINANCING ACTIVITIES** of \$1.1 billion decreased slightly in 1998 compared to 1997. The 1998 use represents net debt repayments. During 1998, we issued Unsecured Notes resulting in proceeds of \$604 million, including the settlement of our treasury lock agreements. These proceeds were used to reduce existing borrowings under our unsecured Term Loan Facility and unsecured Revolving Credit Facility.

Net cash used for financing activities almost tripled in 1997 to \$1.1 billion, primarily reflecting the net payments to PepsiCo, partially offset by the bank borrowings in connection with the Spin-off. This net use was partially offset by the increase in short-term borrowings of \$83 million in 1997 versus a decrease of \$80 million in 1996 and payments on the Revolving Credit Facility.



## Financing Activities

During 1998, we reduced our reliance on bank debt by over \$1 billion by reducing term debt. Term debt was reduced through a combination of proceeds from the debt securities offered under our shelf registration discussed below, proceeds from refranchising activities and operating cash flows. A key component of our financing philosophy is to build balance sheet liquidity and to diversify sources of funding. Consistent with that philosophy, we have taken steps to refinance a portion of our existing bank credit facility referred to below. In 1997, we filed with the SEC a shelf registration statement on Form S-3 with respect to offerings of up to \$2 billion of senior unsecured debt. In early May 1998, we issued \$350 million 7.45% Unsecured Notes due May 15, 2005, and \$250 million 7.65% Unsecured Notes due May 15, 2008, under our shelf registration. The proceeds were used to reduce existing borrowings under our unsecured Term Loan Facility and unsecured Revolving Credit Facility. We may offer and sell from time to time additional debt securities in one or more series, in amounts, at prices and on terms we determine based on market conditions at the time of sale, as discussed in more detail in the registration statement.

To fund the Spin-off, we negotiated a \$5.25 billion bank credit agreement comprised of a \$2 billion senior, unsecured Term Loan Facility and a \$3.25 billion senior, unsecured Revolving Credit Facility which mature on October 2, 2002. Interest is based principally on the London Interbank Offered Rate ("LIBOR") plus a variable margin as defined in the credit agreement. During the year ended December 26, 1998, we made net payments of \$1.04 billion and \$620 million under our unsecured bank Term Loan Facility and the unsecured Revolving Credit Facility, respectively. Amounts outstanding under the Revolving Credit Facility are expected to fluctuate from time to time, but term loan reductions cannot be reborrowed. Such payments reduced amounts outstanding at December 26, 1998, to \$926 million and \$1.82 billion from \$1.97 billion and \$2.44 billion at year-end 1997, on the term facility and revolving facility, respectively. At December 26, 1998, we had unused revolving credit agreement borrowings available aggregating \$1.3 billion, net of outstanding letters of credit of \$173 million. The credit facilities are subject to various affirmative and negative covenants including financial covenants as well as limitations on additional indebtedness including guarantees of indebtedness, cash dividends, aggregate non-U.S. investments, among other things, as defined in the credit agreement.

This substantial indebtedness subjects us to significant interest expense and principal repayment obligations, which are limited in the near term, to prepayment events as defined in the credit agreement. Our highly leveraged capital structure could also adversely affect our ability to obtain additional financing in the future or to undertake refinancings on terms and subject to conditions that are acceptable to us.

Since October 7, 1997, we have been in compliance with the bank covenants. We will continue to closely monitor on an ongoing basis the various operating issues that could, in aggregate, affect our ability to comply with financial covenant requirements.

We continue to use various derivative instruments with the objective of reducing volatility in our borrowing costs. We have utilized interest rate swap agreements to effectively convert a portion of our variable rate (LIBOR) bank debt to fixed rate. During 1998, we entered into treasury lock agreements to partially hedge the anticipated issuance of our senior debt securities discussed above. We have also entered into interest rate arrangements to limit the range of effective interest rates on a portion of our variable rate bank debt. At December 26, 1998, the weighted average interest rate on our variable bank debt, including the effect of derivatives, was 6.2%. Other derivative instruments may be considered from time to time as well to manage our debt portfolio and to hedge foreign currency exchange exposures.

We anticipate that our 1999 combined cash flow from operating and refranchising activities will be lower than 1998 levels primarily because of our expectations of reduced refranchising activity. However, we believe it will be sufficient to support our expected capital spending and still allow us to make significant debt repayments.

## Consolidated Financial Condition

**ASSETS** decreased \$583 million or 11% to \$4.5 billion at year-end 1998. This decrease is primarily attributable to refranchising and store closures and a decrease in U.S. cash which was attributable to improved cash management.

**LIABILITIES** decreased \$1.0 billion or 15% to \$5.7 billion primarily due to net debt repayments. Partially offsetting this decrease is an increase in other liabilities largely due to increased deferred compensation liabilities, pension liabilities and self-insured casualty claims. Additional salary and bonus deferrals and imputed earnings on deferrals under our compensation programs caused the deferred compensation liability to increase. The pension liability increased based on current actuarial valuations. The increase in casualty claims is due to the decision in the current year to effectively self-insure a portion of our 1998 exposure compared to a fully insured program in 1997.

Our operating working capital deficit, which excludes cash, short-term investments and short-term borrowings, is typical of restaurant operations where the vast majority of sales are for cash, and food and supply inventories are relatively small. Our terms of payment to suppliers generally range from 10-30 days. Our operating working capital deficit decreased \$113 million to \$960 million at year-end 1998. This decrease was primarily the result of a decrease in income taxes payable and an increase in deferred tax assets. Also contributing to this decrease was a reduction in the Core Businesses' working capital deficit due to our reduced number of restaurants resulting from our portfolio activities and also due to increased inventories of promotional items. This decrease was partially offset by higher levels of above-store accounts payable and other current liabilities due to timing of payments as well as higher levels of outside services and an increase in total incentive compensation accruals.

# Quantitative and Qualitative Disclosures About Market Risk

## DERIVATIVE INSTRUMENTS

Our policy prohibits the use of derivative instruments for trading purposes, and we have procedures in place to monitor and control their use. Our current use of derivative instruments is primarily limited to interest rate swaps and collars and commodity futures contracts.

Interest rate swaps and collars are entered into with the objective of reducing the volatility in borrowing costs. In 1998 and 1997, we entered into interest rate swaps to effectively convert a portion of our variable rate bank debt to fixed rate. Payment dates and the floating rates indices and reset dates on the swaps match those of our underlying bank debt. At December 26, 1998, our payables under the related swaps aggregated \$1.6 million.

Interest rate collars are entered into with the objective of reducing the impact of variable interest rate changes in our bank debt thereby reducing volatility in borrowing costs. In 1998, we entered into interest rate collars to guarantee an upper (cap) and lower (floor) level of interest rates associated with a portion of bank debt. Collar reset dates and indices match those of our underlying bank debt. We make payments when interest rates fall below the floor level. We receive payments when interest rates rise above the cap. At December 26, 1998, our payables under the related collars were immaterial, and there were no related receivables.

Our credit risk related to these derivatives is dependent upon both the movement in interest rates and the possibility of non-payment by counterparties. We mitigate credit risk by entering into the agreements only with high credit-quality counterparties, netting payments within each contract and netting exposures upon default across all contracts with a given counterparty. However, we believe the risk of default is minimal.

Commodity futures contracts traded on national exchanges are entered into with the objective of reducing food costs. While this hedging activity has historically been limited, hedging activity could increase in the future if we believe it would result in lower total costs. Open contracts, deferred gains and losses and realized gains and losses were not significant for all years presented.

## MARKET RISK OF FINANCIAL INSTRUMENTS

Our primary market risk exposure with regard to financial instruments is to changes in interest rates, principally in the United States. In addition, less than 2% of our debt is denominated in foreign currencies which exposes us to market risk associated with exchange rate movements. Historically, we have not used derivative financial instruments to manage our exposure to foreign currency rate fluctuations since the market risk associated with our foreign currency denominated debt was not considered significant.

At December 26, 1998, a hypothetical 100 basis point increase in short-term interest rates would result in a reduction of approximately \$15 million in annual pre-tax earnings. The estimated reduction is based upon the unhedged portion of our variable

rate debt and assumes no change in the volume or composition of debt at December 26, 1998.

In addition, a hypothetical 100 basis point increase in short-term rates at December 26, 1998 would increase the fair value of our interest rate derivative contracts approximately \$23 million and, the fair value of our Unsecured Notes would decrease approximately \$34 million. Fair value was estimated by discounting the projected interest rate cash flows.

## New Accounting Pronouncements

See Notes to the Consolidated Financial Statements for discussion of new accounting pronouncements.

## Cautionary Statements

From time to time, in both written reports and oral statements, we present "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The statements include those identified by such words as "may," "will," "expect," "believe," "plan" and other similar terminology. These "forward-looking statements" reflect our current expectations and are based upon data available at the time of the statements. Actual results involve risks and uncertainties, including both those specific to the Company and those specific to the industry, and could differ materially from expectations.

Company risks and uncertainties include, but are not limited to, the limited experience of our management group in operating the Company as an independent, publicly owned business; potentially substantial tax contingencies related to the Spin-off, which, if they occur, require us to indemnify PepsiCo; our substantial debt leverage and the attendant potential restriction on our ability to borrow in the future, as well as the substantial interest expense and principal repayment obligations; potential unfavorable variances between estimated and actual liabilities including accruals for wage and hour litigation and the liabilities related to the sale of the Non-core Businesses; our failure or the failure of critical business partners to achieve timely, effective Year 2000 remediation; our ability to complete our conversion plans or the ability of our key suppliers to be Euro-compliant; and the potential inability to identify qualified franchisees to purchase the 408 Company units remaining from the fourth quarter 1997 charge as well as other units at prices we consider appropriate under our strategy to reduce the percentage of system units we operate.

Industry risks and uncertainties include, but are not limited to, global and local business and economic and political conditions; legislation and governmental regulation; competition; success of operating initiatives and advertising and promotional efforts; volatility of commodity costs and increases in minimum wage and other operating costs; availability and cost of land and construction; adoption of new or changes in accounting policies and practices; consumer preferences, spending patterns and demographic trends; political or economic instability in local markets; and currency exchange rates.

# Consolidated Statement of Operations

## TRICON Global Restaurants, Inc. and Subsidiaries

Fiscal years ended December 26, 1998, December 27, 1997 and December 28, 1996

(In millions, except per share amounts)

### Revenues

Company sales

Franchise and license fees

### Costs and Expenses, net

Company restaurants

Food and paper

Payroll and employee benefits

Occupancy and other operating expenses

General, administrative and other expenses

Facility actions net (gain) loss

Unusual charges

Total costs and expenses, net

### Operating Profit

Interest expense, net

### Income (Loss) Before Income Taxes

### Income Tax Provision

### Net Income (Loss)

Basic Earnings Per Common Share

Diluted Earnings Per Common Share

	1998	1997	1996
<b>Revenues</b>			
Company sales	\$ 7,852	\$ 9,112	\$ 9,738
Franchise and license fees	616	573	494
	<b>8,468</b>	<b>9,685</b>	<b>10,232</b>
<b>Costs and Expenses, net</b>			
Company restaurants			
Food and paper	2,521	2,949	3,215
Payroll and employee benefits	2,243	2,614	2,793
Occupancy and other operating expenses	2,030	2,491	2,709
	<b>6,794</b>	<b>8,054</b>	<b>8,717</b>
General, administrative and other expenses	906	959	934
Facility actions net (gain) loss	(275)	247	(37)
Unusual charges	15	184	246
Total costs and expenses, net	<b>7,440</b>	<b>9,444</b>	<b>9,860</b>
<b>Operating Profit</b>	<b>1,028</b>	<b>241</b>	<b>372</b>
Interest expense, net	272	276	300
<b>Income (Loss) Before Income Taxes</b>	<b>756</b>	<b>(35)</b>	<b>72</b>
<b>Income Tax Provision</b>	<b>311</b>	<b>76</b>	<b>125</b>
<b>Net Income (Loss)</b>	<b>\$ 445</b>	<b>\$ (111)</b>	<b>\$ (53)</b>
Basic Earnings Per Common Share	<b>\$ 2.92</b>		
Diluted Earnings Per Common Share	<b>\$ 2.84</b>		



# Consolidated Statement of Cash Flows

## TRICON Global Restaurants, Inc. and Subsidiaries

Fiscal years ended December 26, 1998, December 27, 1997 and December 28, 1996

(in millions)

### Cash Flows – Operating Activities

Net income (loss)

Adjustments to reconcile net income (loss) to net cash provided by operating activities:

Depreciation and amortization

Facility actions net (gain) loss

Unusual charges

Deferred income taxes

Other non-cash charges and credits, net

Changes in operating working capital, excluding effects of acquisitions and dispositions:

Accounts and notes receivable

Inventories

Prepaid expenses, deferred income taxes and other current assets

Accounts payable and other current liabilities

Income taxes payable

Net change in operating working capital

### Net Cash Provided by Operating Activities

### Cash Flows – Investing Activities

Capital spending

Refranchising of restaurants

Sales of Non-core Businesses

Sales of property, plant and equipment

Other, net

### Net Cash Provided by (Used for) Investing Activities

### Cash Flows – Financing Activities

Proceeds from Notes

Proceeds from long-term debt

Proceeds from Term Loan Facility

Proceeds from Revolving Credit Facility

Payments on Revolving Credit Facility

Payments of long-term debt

Short-term borrowings – three months or less, net

Decrease in investments by and advances from PepsiCo

Dividend to PepsiCo

Other, net

### Net Cash Used for Financing Activities

### Effect of Exchange Rate Changes on Cash and Cash Equivalents

### Net (Decrease) Increase in Cash and Cash Equivalents

### Cash and Cash Equivalents – Beginning of Year

### Cash and Cash Equivalents – End of Year

### Supplemental Cash Flow Information

Interest paid

Income taxes paid

	1998	1997	1996
<b>Cash Flows – Operating Activities</b>			
Net income (loss)	\$ 445	\$ (111)	\$ (53)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	417	536	621
Facility actions net (gain) loss	(275)	247	(37)
Unusual charges	15	184	246
Deferred income taxes	3	(138)	(150)
Other non-cash charges and credits, net	175	65	73
Changes in operating working capital, excluding effects of acquisitions and dispositions:			
Accounts and notes receivable	(8)	(22)	(16)
Inventories	4	3	27
Prepaid expenses, deferred income taxes and other current assets	(20)	—	(2)
Accounts payable and other current liabilities	10	3	85
Income taxes payable	(92)	43	(81)
Net change in operating working capital	(106)	27	13
<b>Net Cash Provided by Operating Activities</b>	<b>674</b>	<b>810</b>	<b>713</b>
<b>Cash Flows – Investing Activities</b>			
Capital spending	(460)	(541)	(620)
Refranchising of restaurants	784	770	355
Sales of Non-core Businesses	—	186	—
Sales of property, plant and equipment	58	40	45
Other, net	(80)	11	(29)
<b>Net Cash Provided by (Used for) Investing Activities</b>	<b>302</b>	<b>466</b>	<b>(249)</b>
<b>Cash Flows – Financing Activities</b>			
Proceeds from Notes	604	—	—
Proceeds from long-term debt	4	—	—
Proceeds from Term Loan Facility	—	2,000	—
Proceeds from Revolving Credit Facility	140	2,550	—
Payments on Revolving Credit Facility	(760)	(115)	—
Payments of long-term debt	(1,068)	(65)	(57)
Short-term borrowings – three months or less, net	(53)	83	(80)
Decrease in investments by and advances from PepsiCo	—	(3,281)	(285)
Dividend to PepsiCo	—	(2,369)	—
Other, net	13	59	—
<b>Net Cash Used for Financing Activities</b>	<b>(1,120)</b>	<b>(1,138)</b>	<b>(422)</b>
<b>Effect of Exchange Rate Changes on Cash and Cash Equivalents</b>	<b>(3)</b>	<b>(7)</b>	<b>1</b>
<b>Net (Decrease) Increase in Cash and Cash Equivalents</b>	<b>(147)</b>	<b>131</b>	<b>43</b>
<b>Cash and Cash Equivalents – Beginning of Year</b>	<b>268</b>	<b>137</b>	<b>94</b>
<b>Cash and Cash Equivalents – End of Year</b>	<b>\$ 121</b>	<b>\$ 268</b>	<b>\$ 137</b>
<b>Supplemental Cash Flow Information</b>			
Interest paid	\$ 303	\$ 64	\$ 34
Income taxes paid	310	210	325

See accompanying Notes to Consolidated Financial Statements

# Consolidated Balance Sheet

TRICON Global Restaurants, Inc. and Subsidiaries

December 26, 1998 and December 27, 1997

(in millions)

## ASSETS

### Current Assets

Cash and cash equivalents

Short-term investments, at cost

Accounts and notes receivable, less allowance: \$17 in 1998 and \$20 in 1997

Inventories

Prepaid expenses, deferred income taxes and other current assets

### Total Current Assets

Property, Plant and Equipment, net

Intangible Assets, net

Investments in Unconsolidated Affiliates

Other Assets

### Total Assets

## LIABILITIES AND SHAREHOLDERS' DEFICIT

### Current Liabilities

Accounts payable and other current liabilities

Income taxes payable

Short-term borrowings

### Total Current Liabilities

Long-term Debt

Other Liabilities and Deferred Credits

Deferred Income Taxes

### Total Liabilities

### Shareholders' Deficit

Preferred stock, no par value, 250 shares authorized; no shares issued

Common stock, no par value, 750 shares authorized; 153 and 152 shares issued and outstanding in 1998 and 1997, respectively

Accumulated deficit

Accumulated other comprehensive income

### Total Shareholders' Deficit

### Total Liabilities and Shareholders' Deficit

	1998	1997
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 121	\$ 268
Short-term investments, at cost	87	33
Accounts and notes receivable, less allowance: \$17 in 1998 and \$20 in 1997	155	149
Inventories	68	73
Prepaid expenses, deferred income taxes and other current assets	194	163
<b>Total Current Assets</b>	<b>625</b>	<b>686</b>
Property, Plant and Equipment, net	2,896	3,261
Intangible Assets, net	851	812
Investments in Unconsolidated Affiliates	159	143
Other Assets	200	212
<b>Total Assets</b>	<b>\$ 4,531</b>	<b>\$ 5,114</b>
<b>LIABILITIES AND SHAREHOLDERS' DEFICIT</b>		
<b>Current Liabilities</b>		
Accounts payable and other current liabilities	\$ 1,283	\$ 1,263
Income taxes payable	94	195
Short-term borrowings	96	124
<b>Total Current Liabilities</b>	<b>1,473</b>	<b>1,582</b>
Long-term Debt	3,436	4,551
Other Liabilities and Deferred Credits	720	568
Deferred Income Taxes	65	33
<b>Total Liabilities</b>	<b>5,694</b>	<b>6,734</b>
<b>Shareholders' Deficit</b>		
Preferred stock, no par value, 250 shares authorized; no shares issued	—	—
Common stock, no par value, 750 shares authorized; 153 and 152 shares issued and outstanding in 1998 and 1997, respectively	1,305	1,271
Accumulated deficit	(2,318)	(2,763)
Accumulated other comprehensive income	(150)	(128)
<b>Total Shareholders' Deficit</b>	<b>(1,163)</b>	<b>(1,620)</b>
<b>Total Liabilities and Shareholders' Deficit</b>	<b>\$ 4,531</b>	<b>\$ 5,114</b>



# Consolidated Statement of Shareholders' (Deficit) Equity and Comprehensive Income

## TRICON Global Restaurants, Inc. and Subsidiaries

Fiscal years ended December 26, 1998, December 27, 1997 and December 28, 1996

(in millions)

	Issued Common Stock		Accumulated Deficit	Investments by and Advances from PepsiCo	Accumulated Other Comprehensive Income	Total
	Shares	Amount				
Balance at December 30, 1995				\$ 4,604	\$ (29)	\$ 4,575
Comprehensive Income:						
Net loss				(53)		(53)
Foreign currency translation adjustment					2	2
Minimum pension liability adjustment, (includes tax of \$2 million)					(2)	(2)
Net investments by and advances from PepsiCo				(283)		(283)
Balance at December 28, 1996				\$ 4,268	\$ (29)	\$ 4,239
Comprehensive Income:						
Net income prior to Spin-off				283		283
Net loss after Spin-off			(394)			(394)
Foreign currency translation adjustment					(101)	(101)
Minimum pension liability adjustment, (includes tax of \$2 million)					2	2
Net investments by and advances from PepsiCo				(1,152)		(1,152)
Spin-off dividend and partial repayment of advances			(2,369)	(2,131)		(4,500)
Issuance of shares of common stock, no par value, in connection with the Spin-off	152					—
Contribution to capital of remaining unpaid advances		1,268		(1,268)		—
Stock option exercises		3				3
Balance at December 27, 1997	152	\$ 1,271	\$ (2,763)	\$ —	\$ (128)	\$ (1,620)
Comprehensive Income:						
Net income			445			445
Foreign currency translation adjustment					(20)	(20)
Minimum pension liability adjustment (includes tax of \$1 million)					(2)	(2)
Adjustment to opening equity related to net advances from PepsiCo		12				12
Stock option exercises (includes tax benefits of \$3 million)	1	22				22
Balance at December 26, 1998	153	\$ 1,305	\$ (2,318)	\$ —	\$ (150)	\$ (1,163)
Total Comprehensive (Loss) Income for the years:						
December 28, 1996						\$ (53)
December 27, 1997						(210)
December 26, 1998						423

See accompanying Notes to Consolidated Financial Statements.

# Notes to Consolidated Financial Statements

(tabular amounts in millions, except share data)

## Note 1: Description of Business

TRICON Global Restaurants, Inc. and Subsidiaries (collectively referred to as "TRICON" or the "Company") was created as an independent, publicly owned company on October 6, 1997 (the "Spin-off Date") via a tax-free distribution by our former parent, PepsiCo, Inc. ("PepsiCo"), of our Common Stock (the "Distribution" or "Spin-off") to its shareholders. TRICON is the world's largest quick service restaurant company based on the number of system units, with more than 29,000 restaurants in 101 countries and territories. References to TRICON throughout these Consolidated Financial Statements are made using the first person notations of "we" or "our." The worldwide business of our core businesses of KFC, Pizza Hut and Taco Bell ("Core Business(es)"), include the operations, development and franchising and licensing of a system of both traditional and non-traditional quick service restaurant units featuring dine-in, carryout and, in some instances, drive-thru or delivery service. Each Core Business has proprietary menu items and emphasizes the preparation of food with high quality ingredients as well as unique recipes and special seasonings to provide appealing, tasty and attractive food at competitive prices. We also previously operated other non-core concepts disposed of in 1997, which included California Pizza Kitchen, Chevys Mexican Restaurant, D'Angelo's Sandwich Shops, East Side Mario's and Hot 'n Now (collectively, the "Non-core Businesses"). As of year-end 1998, 32% of total worldwide units were operated by us or international joint ventures in which we participate and 68% by our franchisees and licensees. Approximately 31% of our system units are located outside the U.S. In late 1994, we determined that each Core Business system should be rebalanced toward franchising and that underperforming units should be closed and, since that time, 3,730 units have been refranchised and 1,941 units have been closed through December 26, 1998.

## Note 2: Summary of Significant Accounting Policies

Our preparation of the accompanying Consolidated Financial Statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from our estimates.

### PRINCIPLES OF CONSOLIDATION AND BASIS OF PREPARATION

The accompanying Consolidated Financial Statements present our financial position, results of operations and cash flows as if we had been an independent, publicly owned company for all prior periods presented. Intercompany accounts and transactions have been eliminated. Investments in unconsolidated affiliates in which we exercise significant influence but do not control are accounted for by the equity method. Our share of the net income or loss of those unconsolidated affiliates and net foreign exchange gains or losses are included in general, administrative and other expenses. The Consolidated Financial Statements prior to the Spin-off Date represent the combined worldwide operations of the Core Businesses and the Non-core Businesses disposed of in 1997.

In addition, PepsiCo made certain allocations of its previously unallocated interest and general and administrative expenses related to the years ended 1997 and 1996, as well as computations of separate tax provisions for its restaurant segment, to facilitate the presentation.

Prior to the Spin-off, our operations were financed through our operating cash flows, refranchising proceeds and investments by and advances from PepsiCo. For this reason, our historical financial statements prior to the Spin-off include interest expense on our relatively insignificant external debt plus an allocation of interest expense which had not previously been allocated by PepsiCo. PepsiCo based its interest allocations on its weighted average interest rate applied to the average annual balance of investments by and advances from PepsiCo.

PepsiCo based its allocations of general and administrative expenses on our revenue as a percent of PepsiCo's total revenue.

The amounts, by year, of the historical allocations described above are as follows:

	1997 through Spin-off Date	1996
Interest allocated	\$ 188	\$ 275
PepsiCo weighted-average interest rate	6.1%	6.2%
General and administrative expense allocated	\$ 37	\$ 53

We believe that the bases of allocation of interest expense and general and administrative expenses were reasonable based on the facts and circumstances available at the date of their allocation. However, based on current information, such amounts are not indicative of amounts which we would have incurred as an independent, publicly owned company for all periods presented.

In addition, as noted in our Consolidated Statement of Shareholders' (Deficit) Equity and Comprehensive Income, our

capital structure changed in 1997 as a result of the Distribution and bears little relationship to the average net outstanding investments by and advances from PepsiCo prior to the Spin-off. In connection with the Spin-off, we borrowed \$4.55 billion to fund a dividend and repayments to PepsiCo, which exceeded the net aggregate balance owed at the Spin-off Date by \$1.1 billion.

For periods prior to the Spin-off, PepsiCo calculated income tax expense, to the extent possible, as if we had filed separate income tax returns. As PepsiCo managed its tax position on a consolidated basis, which takes into account the results of all of its businesses, our historical effective tax rates prior to 1998 are not indicative of our future tax rates.

#### CHANGES IN ACCOUNTING PRINCIPLES.

**COMPREHENSIVE INCOME.** Effective December 28, 1997, we adopted Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income." This Statement requires that all items recognized under accounting standards as components of comprehensive earnings be reported in the financial statements. We have included these disclosures in the accompanying Consolidated Statement of Shareholders' (Deficit) Equity and Comprehensive Income. We have classified items of other comprehensive earnings by their nature in our financial statements. Prior years' financial statements have been reclassified to conform to these requirements.

Accumulated Other Comprehensive Income includes reclassification amounts as follows:

	1998	1997	1996
Foreign currency translation adjustment arising during the period	\$ (21)	\$ (90)	\$ 2
Less: Foreign currency translation adjustment included in net income (loss)	1	(11)	—
Net foreign currency translation adjustment	\$ (20)	\$ (101)	\$ 2

Accumulated Other Comprehensive Income consisted of the following components as of December 26, 1998 and December 27, 1997:

	1998	1997
Foreign currency translation adjustment	\$ (148)	\$ (128)
Minimum pension liability adjustment	(2)	—
Total accumulated other comprehensive income	\$ (150)	\$ (128)

**SEGMENT DISCLOSURES.** Effective December 28, 1997, we adopted SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information" ("SFAS 131"). This Statement supersedes SFAS No. 14, "Financial Reporting for Segments of a Business Enterprise" and requires that a public

company report annual and interim financial and descriptive information about its reportable operating segments. Operating segments, as defined, are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. This Statement allows aggregation of similar operating segments into a single operating segment if the businesses are considered similar under the criteria of this Statement. For purposes of applying this Statement, we consider our U.S. Core Businesses to be similar and therefore have aggregated them. As required, our financial information has been reported on the basis that we use internally for evaluating segment performance and deciding how to allocate resources to segments. Upon adoption of SFAS 131, certain corporate expenses PepsiCo previously allocated to our business segments are now reported as unallocated expenses. We have restated prior year amounts to be comparable to the current year presentation.

**INTERNAL DEVELOPMENT COSTS.** Effective March 18, 1998, we adopted Emerging Issues Task Force Issue No. 97-11 ("EITF 97-11"), "Accounting for Internal Costs Relating to Real Estate Property Acquisitions." EITF 97-11 limits the capitalization of internal real estate acquisition costs to those site-specific costs incurred subsequent to the time that the real estate acquisition is considered probable. We consider acquisition of the property probable upon final site approval. Prior to the adoption of EITF 97-11, all preacquisition real estate activities were considered capitalizable. The adoption of EITF 97-11 resulted in additional expenses of \$6 million (\$3 million after-tax) in 1998 for internal development costs no longer capitalizable.

**FISCAL YEAR.** Our fiscal year ends on the last Saturday in December and, as a result, a fifty-third week is added every five or six years. Fiscal years 1998, 1997 and 1996 comprised 52 weeks. The first, second and third quarters of each year include 12 weeks each, while the fourth quarter includes 16 weeks. Our subsidiaries operate on similar fiscal calendars with period end dates suited to their businesses. Period end dates are within one week of TRICON's period end date with the exception of our international businesses, which close one period or month earlier to facilitate consolidated reporting.

**DIRECT MARKETING COSTS.** We report substantially all of our direct marketing costs in occupancy and other operating expenses in the Consolidated Statement of Operations, which include costs of advertising and other marketing activities. We charge direct marketing costs to expense ratably in relation to revenues over the year in which incurred. Direct marketing costs deferred at year-end consist of media and related ad production costs. We expense these costs in the first year the media or ad is used. Our advertising expenses were \$462 million, \$544 million and \$571 million in 1998, 1997 and 1996, respectively.

**RESEARCH AND DEVELOPMENT EXPENSES.** Research and development expenses, which we expense as incurred, were \$21 million, \$21 million and \$20 million in 1998, 1997 and 1996, respectively.

**STOCK-BASED EMPLOYEE COMPENSATION.** We measure stock-based employee compensation cost for financial statement purposes in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and its related interpretations and include pro forma information in Note 13 as required by Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Accordingly, we measure compensation cost for the stock option grants to our employees as the excess of the average market price of our Common Stock at the grant date over the amount the employee must pay for the stock. Our policy is to generally grant stock options at the average market price of the underlying Common Stock at the date of grant.

**EARNINGS (LOSS) PER COMMON SHARE.** In the accompanying Consolidated Statement of Operations, we have omitted loss per share information for 1997 and 1996 as our capital structure as an independent, publicly owned company did not exist in those years.

**DERIVATIVE INSTRUMENTS.** From time to time, we utilize interest rate swaps and collars to hedge our exposure to fluctuations in variable interest rates.

We recognize the interest differential to be paid or received on an interest rate swap as an adjustment to interest expense as the differential occurs. We recognize the interest differential to be paid or received on an interest rate collar as an adjustment to interest expense only if the interest rate falls below or exceeds the contractual collared range. We reflect the recognized interest differential not yet settled in cash in the accompanying Consolidated Balance Sheet as a current receivable or payable. If we were to terminate an interest rate swap or collar position, any gain or loss realized upon termination would be deferred and amortized to interest expense over the remaining term of the underlying debt instrument it was intended to modify or would be recognized immediately if the underlying debt instrument were settled prior to maturity.

We defer gains and losses on futures contracts that are designated and effective as hedges of future commodity purchases and include them in the cost of the related raw materials when purchased. Changes in the value of futures contracts that we use to hedge commodity purchases are highly correlated to the changes in the value of the purchased commodity. If the degree of correlation between the futures contracts and the purchase contracts were to diminish such that the two were no longer considered highly correlated, we would recognize in income subsequent changes in the value of the futures contracts.

**CASH AND CASH EQUIVALENTS.** Cash equivalents represent funds we have temporarily invested (with original maturities not exceeding three months) as part of managing our day-to-day operating cash receipts and disbursements.

**INVENTORIES.** We value our inventories at the lower of cost (computed on the first-in, first-out method) or net realizable value.

**PROPERTY, PLANT AND EQUIPMENT.** We state property, plant and equipment ("PP&E") at cost less accumulated depreciation and amortization, impairment writedowns and valuation allowances. We calculate depreciation and amortization on a straight-line basis over the estimated useful lives of the assets as follows: 5 to 25 years for buildings and improvements and 3 to 20 years for machinery and equipment. We suspend depreciation and amortization on assets related to restaurants that are held for disposal. Our depreciation and amortization expense was \$372 million, \$460 million and \$521 million in 1998, 1997 and 1996, respectively.

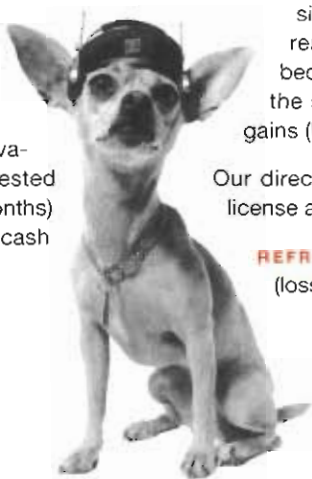
**INTANGIBLE ASSETS.** Intangible assets include both identifiable intangibles and goodwill arising from the allocation of purchase prices of businesses acquired. Where appropriate, the intangibles are allocated to the individual store level at the times of acquisition. We base amounts assigned to identifiable intangibles on independent appraisals or internal estimates. Goodwill represents the residual purchase price after allocation to all identifiable net assets. Our intangible assets are stated at historical allocated cost less accumulated amortization, impairment writedowns and valuation allowances. We amortize intangible assets on a straight-line basis as follows: 20 years for reacquired franchise rights, 3 to 34 years for trademarks and other identifiable intangibles and 20 years for goodwill. We suspend amortization on intangible assets allocated to restaurants that are held for disposal. Our amortization expense was \$52 million, \$70 million and \$95 million in 1998, 1997 and 1996, respectively.

**FRANCHISE AND LICENSE FEES.** We execute franchise or license agreements covering each point of distribution which provide the terms of our arrangement with the franchisee/licensee. Our franchise and certain license agreements generally require the franchisee/licensee to pay an initial, non-refundable fee. Our agreements also require continuing fees based upon a percentage of sales. Subject to our approval and payment of a renewal fee, a franchisee may generally renew its agreement upon its expiration.

We recognize initial fees as revenue when we have performed substantially all initial services required by the franchising/licensing agreement, which is generally upon opening of a store. We recognize continuing fees as earned with an appropriate provision for estimated uncollectible amounts. We recognize renewal fees in earnings when a renewal agreement becomes effective. We include initial fees collected upon the sale of a restaurant to a franchisee in refranchising gains (losses).

Our direct costs of the sales and servicing of franchise and license agreements are charged to expense as incurred.

**REFRANCHISING GAINS (LOSSES).** Refranchising gains (losses) include gains or losses on sales of our restaurants



to new and existing franchisees and the related initial franchise fees. We include direct administrative costs of refranchising in the gain or loss calculation. We recognize gains on restaurant refranchisings when the sale transaction closes, the franchisee has a minimum amount of the purchase price in at-risk equity and we are satisfied that the franchisee can meet its financial obligations. Otherwise, we defer refranchising gains until those criteria have been met. We recognize estimated losses on restaurants to be refranchised and suspend depreciation and amortization when: (1) we make a decision to refranchise a store; (2) the estimated fair value less costs to sell is less than the carrying amount of the store; and (3) the store can be immediately removed from operations. When we make a decision to retain a store previously held for refranchising, we revalue the store at the lower of its net book value at our original disposal decision date less normal depreciation during the period held for disposal or its current fair market value. This value becomes the store's new cost basis. We charge (or credit) any difference between the store's carrying amount and its new cost to refranchising gains (losses). When we make a decision to close a store previously held for refranchising, we reverse any previously recognized refranchising loss and then record the store closure costs as described below.

**STORE CLOSURE COSTS.** To conform to the Securities and Exchange Commission's interpretation of Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," our store closure accounting policy was changed in 1998. Effective for closure decisions made on or subsequent to April 23, 1998, we recognize store closure costs when we have closed the restaurant within the same quarter our decision is made. Prior to April 23, 1998, we recognized store closure costs and generally suspended depreciation and amortization when we decided to close a restaurant in a future quarter. Store closure costs include the cost of writing-down (impairing) the carrying amount of a restaurant's assets to estimated fair market value less costs of disposal. The impact of this accounting policy change was not significant.

When we make a decision to retain a store previously held for closure, we revalue the store at the lower of net book value at the original disposal decision date less normal depreciation during the period held for disposal or the current fair market value. This value becomes the store's new cost basis. We charge (or credit) any difference between the store's carrying amount and its new cost to store closure costs. When we make a decision to refranchise a store previously held for closure, we reverse any previously recognized store closure costs and then record the estimated refranchising loss, if any, as described above.

In addition, for all periods presented, we recorded a liability for the net present value of any remaining operating lease obligations after the expected closure date, net of estimated sublease income, if any. If we decide to retain or refranchise a store held for closure, we reverse the post-closing lease liability previously recorded.

**IMPAIRMENT OF LONG-LIVED ASSETS TO BE HELD AND USED IN THE BUSINESS.** We review our long-lived assets, including any allocated intangible assets, related to each restaurant to be held and used in the business semi-annually for impairment, or whenever events or changes in circumstances indicate that the carrying amount of a restaurant may not be recoverable. We evaluate restaurants using a "two-year history of operating losses" as our primary indicator of potential impairment. Based on the best information available, we write down an impaired restaurant to its estimated fair market value, which becomes its new cost basis. We generally measure estimated fair market value by discounting estimated future cash flows. In addition, when we decide to close a store beyond the quarter in which the closure decision is made, it is reviewed for impairment. The impairment evaluation is based on the estimated cash flows from continuing use until the expected disposal date plus the expected terminal value.

Considerable management judgment is necessary to estimate future cash flows. Accordingly, actual results could vary significantly from such estimates.

**IMPAIRMENT OF INVESTMENTS IN UNCONSOLIDATED AFFILIATES AND ENTERPRISE-LEVEL GOODWILL.** Our methodology for determining and measuring impairment of our investments in unconsolidated affiliates and enterprise-level goodwill is similar to the methodology we use for our restaurants except (a) the recognition test for an investment in an unconsolidated affiliate compares the carrying amount of our investment to a forecast of our share of the unconsolidated affiliate's undiscounted cash flows including interest and taxes instead of undiscounted cash flows before interest and taxes used for our restaurants and (b) enterprise-level goodwill is generally evaluated at a country level instead of by individual restaurant. Also, we record impairment charges related to our investments in unconsolidated affiliates whenever other circumstances indicate that a decrease in the value of an investment has occurred which is other than temporary.

**RECLASSIFICATIONS.** We have reclassified certain items in the accompanying Consolidated Financial Statements for prior periods to be comparable with the classification we adopted for the fiscal year ended December 26, 1998. These reclassifications had no effect on previously reported net losses.

### Note 3: Earnings Per Common Share ("EPS")

Net income	1998
	\$ 445
Basic EPS:	
Weighted-average common shares outstanding	153
Basic EPS	\$ 2.92
Diluted EPS:	
Weighted-average common shares outstanding	153
Shares assumed issued on exercise of dilutive share equivalents	20
Shares assumed purchased with proceeds of dilutive share equivalents	(17)
Shares applicable to diluted earnings	156
Diluted EPS	\$ 2.84

Unexercised employee stock options to purchase approximately 1 million shares of our Common Stock for the year ended December 26, 1998 were not included in the computation of diluted EPS because their exercise prices were greater than the average market price of our Common Stock during the year.

We have omitted EPS data for the years ended December 27, 1997 and December 28, 1996 since we were not an independent, publicly owned company with a capital structure of our own during those years.

### Note 4: Items Affecting Comparability of Net Income (Loss)

#### 1997 FOURTH QUARTER CHARGE

Our 1997 fourth quarter charge of \$530 million (\$425 million after-tax) represented actions taken to refocus our business. The charge included estimates for (1) costs of closing underperforming stores during 1998, primarily at Pizza Hut and internationally; (2) reduction to fair market value, less costs to sell, of the carrying amounts of certain restaurants we intended to re franchise in 1998; (3) impairment of certain restaurants intended to be used in the business; (4) impairment of certain joint venture investments to be retained; and (5) costs of related personnel reductions. The 1997 fourth quarter charge included liabilities of approximately \$129 million and asset writedowns of approximately \$401 million. The liabilities consisted primarily of occupancy-related costs and, to a much lesser extent,

severance. The components of the 1997 fourth quarter charge are detailed below:

	U.S.	International	Worldwide
Store closure costs	\$ 141	\$ 72	\$ 213
Refranchising losses	77	59	136
Impairment charges	12	49	61
Total facility actions net loss	230	180	410
Impairment of investments in unconsolidated affiliates	—	79	79
Severance and other	18	23	41
Total unusual charges	18	102	120
Total fourth quarter charges	\$ 248	\$ 282	\$ 530
Total fourth quarter charges, after-tax	\$ 176	\$ 249	\$ 425

In 1998, favorable adjustments of \$54 million (\$33 million after-tax) and \$11 million (\$7 million after-tax) were included in facility actions net gain and unusual charges, respectively. These adjustments primarily relate to decisions to retain certain stores originally expected to be disposed of, better-than-expected proceeds from refranchisings and lease settlements with certain lessors related to stores closed.

#### FACILITY ACTIONS NET (GAIN) LOSS

	1996 <sup>(a)</sup>		1997 <sup>(b)</sup>		1998	
	Pre-Tax	After-Tax	Pre-Tax	After-Tax	Pre-Tax	After-Tax
Facility actions net (gain) loss	\$ (275)	\$ (162)	\$ 247	\$ 163	\$ (37)	\$ (21)

(a) 1996 includes \$54 million (\$33 million after-tax) of favorable adjustments to our 1997 fourth quarter charge described above.

(b) 1997 includes \$410 million (\$330 million after-tax) related to our fourth quarter charge described above.

Facility actions net (gain) loss consists of three components:

- Gains and losses on sales of our restaurants to new and existing franchisees,
- Costs of closing our underperforming stores and
- Impairment charges both for restaurants we intend to continue to use in the business and, since April 23, 1998, restaurants we intend to close beyond the quarter in which the closure decision is made.

The components of facility actions net (gain) loss for 1998, 1997 and 1996 were as follows:

#### U.S.

Refranchising gains<sup>(a)</sup>  
Store closure costs  
Impairment charges  
Facility actions net (gain) loss

#### International

Refranchising gains<sup>(a)</sup>  
Store closure costs, net  
Impairment charges  
Facility actions net (gain) loss

#### Worldwide

Refranchising gains<sup>(a)</sup>  
Store closure costs  
Impairment charges<sup>(c)</sup>  
Facility actions net (gain) loss

1998		1997		1996
Total	(Excluding 1997 4th Qtr. Charge Adjustments)	Total	(Excluding 1997 4th Qtr. Charge)	
\$ (275)	\$ (249)	\$ (67)	\$ (144)	\$ (134)
(9)	27	154	13	45
28	28	59	47	54
(256)	(194)	146	(84)	(35)
(4)	(32)	(45)	(104)	(5)
(18)	2	94	22	(5)
3	3	52	3	8
(19)	(27)	101	(79)	(2)
(279)	(281)	(112)	(248)	(139)
(27)	29	248	35	40
31	31	111	50	62
\$ (275)	\$ (221)	\$ 247	\$ (163)	\$ (37)

(a) Includes initial franchise fees in the U.S. of \$32 million, \$39 million and \$22 million in 1998, 1997 and 1996, respectively. See Note 5.

(b) Includes a tax-free gain of \$100 million in 1997 from refranchising our restaurants in New Zealand through an initial public offering.

(c) Impairment charges for 1998 were recorded against the following asset categories:

Property, plant and equipment	\$ 25
Intangible assets:	
Goodwill	4
Reacquired franchise rights	2
Total impairment	<u>\$ 31</u>

In executing our refranchising initiatives, we most often offer groups of restaurants. As discussed in Note 2, we only consider the underlying stores "held for disposal" where a group of stores is expected to be sold at a loss.

The following table displays a summary of the 1998 activity related to stores closed or held for closure and stores refranchised or held for refranchising. We believe that the remaining carrying amounts for facility actions are adequate to complete our current plan of disposal.



	Carrying Amount at 12/27/97	(Income) Expense Impact			Carrying Amount at 12/26/98
		New Decisions	Estimate/ Decision Changes	Utilizations	
Asset Valuation					
Allowances	\$ 291	\$ 16	\$ (33)	\$ (148)	\$ 1
Liabilities	115	5	(8)	(36)	1
					<b>\$ 127</b>
					<b>77</b>

The carrying value of assets held for disposal (which include stores, a minority interest investment in a non-core business and our idle processing facility in Wichita, Kansas) by reportable operating segment as of December 26, 1998 and December 27, 1997 were as follows:

	1998	1997
U.S.	\$ 111	\$ 149
International	46	93
Total	\$ 157	\$ 242

We anticipate that all assets with the possible exception of the Wichita facility will be sold within the next twelve months.

The results of operations for stores held for disposal or disposed of in 1998 and 1997 were as follows:

	1998	1997
Stores held for disposal or disposed of in 1998:		
Sales	\$ 987	\$ 1,528
Restaurant Margin	95	98
Stores disposed of in 1997:		
Sales	\$ —	\$ 631
Restaurant Margin	—	48

We expect that the loss of restaurant margin from the disposal of these stores will be mitigated by the increased royalty fees for stores refranchised, lower general and administrative expenses and reduced interest costs primarily resulting from the reduction of debt by the after-tax cash proceeds from our refranchising activities. The margin reported above includes the benefit from the suspension of depreciation and amortization of approximately \$37 million (\$23 million in the U.S. and \$14 million in International) and \$17 million in the U.S. in 1998 and 1997, respectively, on assets held for disposal.

#### UNUSUAL CHARGES

	1998	1997	1996
U.S.	\$ 11	\$ 85	\$ 246
International	4	99	—
Worldwide	\$ 15	\$ 184	\$ 246
After-tax	\$ 3	\$ 165	\$ 189

Unusual charges in 1998 included: (1) an increase in the estimated costs of settlement of certain wage and hour litigation and associated defense and other costs incurred; (2) severance and other exit costs related to strategic decisions to streamline the infrastructure of our international businesses; (3) favorable adjustments to our 1997 fourth quarter charge related to anticipated

actions that were not taken, primarily severance; (4) writedown to estimated fair market value less costs to sell of our minority interest in a privately held non-core business, previously carried at cost, now held for sale; and (5) reversals of certain valuation allowances and lease liabilities relating to better-than-expected proceeds from the sale of properties and settlement of lease liabilities associated with properties retained upon the sale of a Non-core Business.

Unusual charges in 1997 included: (1) \$120 million (\$125 million after-tax) of unusual asset impairment and severance charges included in our 1997 fourth quarter charge described above; (2) charges to further reduce the carrying amounts of the Non-core Businesses held for disposal to estimated market value, less costs to sell; and (3) charges relating to the estimated costs of settlement of certain wage and hour litigation and the associated defense and other costs incurred.

Unusual charges in 1996 resulted from our decision to dispose of our Non-core Businesses. The charge represented the reduction of the carrying amounts of the Non-core Businesses to estimated fair market value, less costs to sell. The estimated fair market value was initially determined by using estimated selling prices based upon the opinion of an investment banking firm retained to assist in the selling activity.

## Note 5: Franchise and License Fees

Our franchise and certain license arrangements for our traditional and non-traditional points of distribution, respectively, provide for initial fees. The agreements also require the franchisee or licensee to pay continuing fees based upon a percentage of sales. Initial franchise fees from refranchising activities arise from an initiative we adopted in late 1994 to reduce our percentage ownership of total system units by selling our stores to new and existing franchisees. We include initial franchise fees from refranchising activities as part of refranchising gains.

	1998	1997	1996
Initial fees, including renewal fees	\$ 67	\$ 86	\$ 43
Initial franchise fees			
from refranchising activities	(44)	(41)	(22)
	23	45	21
Continuing fees	593	528	473
	\$ 616	\$ 573	\$ 494

Initial fees in 1997 include \$24 million of special KFC renewal fees.

## Note 6: Property, Plant and Equipment, net

	1998	1997
Land	\$ 707	\$ 834
Buildings and improvements	2,861	3,163
Capital leases, primarily buildings	124	152
Machinery and equipment	1,795	2,040
	<b>5,487</b>	<b>6,189</b>
Accumulated depreciation and amortization	(2,491)	(2,720)
Valuation allowances	(100)	(208)
	<b>\$ 2,896</b>	<b>\$ 3,261</b>

## Note 7: Intangible Assets, net

	1998	1997
Reacquired franchise rights	\$ 418	\$ 544
Trademarks and other identifiable intangibles	123	132
Goodwill	110	136
	<b>\$ 651</b>	<b>\$ 812</b>

We have subtracted accumulated amortization of \$473 million and \$508 million and valuation allowances of \$18 million and \$66 million at year-end 1998 and 1997, respectively, in determining the above amounts.

## Note 8: Accounts Payable and Other Current Liabilities

	1998	1997
Accounts payable	\$ 476	\$ 453
Accrued compensation and benefits	310	297
Other accrued taxes	98	103
Other current liabilities	399	410
	<b>\$ 1,283</b>	<b>\$ 1,263</b>



## Note 9: Short-term Borrowings and Long-term Debt

	1998	1997
<b>Short-term Borrowings</b>		
Current maturities of long-term debt	\$ 46	\$ 19
Other	50	105
	<b>\$ 96</b>	<b>\$ 124</b>
<b>Long-term Debt</b>		
Senior, unsecured Term Loan Facility, due October 2002	\$ 926	\$ 1,968
Senior, unsecured Revolving Credit Facility, expires October 2002	1,815	2,435
Senior, Unsecured Notes, due May 2005 (7.45%)	352	—
Senior, Unsecured Notes, due May 2008 (7.65%)	251	—
Capital lease obligations (see Note 10)	117	140
Other, due through 2010 (5% - 12%)	21	27
	<b>3,482</b>	<b>4,570</b>
Less current maturities of long-term debt	(46)	(19)
	<b>\$ 3,436</b>	<b>\$ 4,551</b>

We have included any related discount or premium in the carrying amount of long-term debt.

On October 2, 1997, we entered into a \$5.25 billion bank credit agreement comprised of a \$2 billion senior, unsecured Term Loan Facility and a \$3.25 billion senior, unsecured Revolving Credit Facility (collectively referred to as the "Facilities") which mature on October 2, 2002. Our principal U.S. Subsidiaries have guaranteed the Facilities. Amounts borrowed under the Term Loan Facility that we repay may not be reborrowed.

We used \$4.5 billion of the initial \$4.55 billion borrowed under the Facilities to make a Spin-off related payment to PepsiCo. We used the remaining \$50 million of the proceeds to provide cash collateral securing certain obligations previously secured by PepsiCo, to pay fees and expenses related to the Spin-off and establishment of the Facilities and for general corporate purposes. Interest on amounts borrowed is payable at least quarterly at rates which are variable, based principally on the London Interbank Offered Rate ("LIBOR") plus a variable margin factor as defined in the credit agreement. At December 26, 1998, the weighted average interest rate on our variable rate debt was 6.2%, which includes the effects of associated interest rate swaps and collars. See Note 11 for a discussion of our use of interest rate swaps, our management of inherent credit risk and fair value information related to debt and interest rate swaps.

At December 26, 1998, we had unused borrowings available under the Revolving Credit Facility of \$1.3 billion, net of outstanding letters of credit of \$173 million. Once we have repaid

the Term Loan in full, mandatory prepayments may be required of the Revolving Credit Facility which would reduce the amount available. Absent this circumstance, under the terms of the Revolving Credit Facility, we may borrow up to \$3.25 billion less outstanding letters of credit until maturity. We pay a facility fee on the Revolving Credit Facility. The variable margin factor and facility fee rate is determined based on the more favorable of our leverage ratio or third-party senior debt ratings as defined in the agreement. Facility fees accrued at December 26, 1998 were \$1.7 million.

The Facilities are subject to various covenants including financial covenants relating to maintenance of specific leverage and fixed charge coverage ratios. In addition, the Facilities contain affirmative and negative covenants including, among other things, limitations on certain additional indebtedness including guarantees of indebtedness, cash dividends, aggregate non-U.S. investment and certain other transactions, as defined in the agreement. Since October 6, 1997, we have complied with all covenants governing the Facilities. The Facilities contain mandatory prepayment terms for certain capital market transactions and refranchising of restaurants as defined in the agreement.

In 1997, we filed with the Securities and Exchange Commission a shelf registration statement with respect to offerings of up to \$2 billion of senior unsecured debt. In May 1998, we issued \$350 million 7.45% Unsecured Notes due May 15, 2005 and \$250 million 7.65% Unsecured Notes due May 15, 2008 (collectively referred to as the "Notes"). We used the proceeds, net of issuance costs, to reduce existing borrowings under the Facilities. We carry the Notes net of related discounts, which are being amortized over the life of the Notes. The unamortized discount for both issues was approximately \$1.1 million at December 26, 1998 and the amortization during 1998 was not significant. Interest is payable May 15 and November 15 and commenced on November 15, 1998. In anticipation of the issuance of the Notes, we entered into \$600 million in treasury locks (the "Locks") to reduce interest rate sensitivity in pricing of the Notes. Concurrent with the issuance of the Notes, the Locks were settled at a gain, which is being amortized to interest expense over the life of the Notes. The effective interest rate on the 2005 Notes and the 2008 Notes is 7.6% and 7.8%, respectively.

Interest expense on the short-term borrowings and long-term debt was \$291 million, \$290 million and \$310 million in 1998, 1997 and 1996, respectively. Interest expense in 1997 and 1996 included the PepsiCo interest allocation of \$188 million and \$275 million, respectively.

The annual maturities of long-term debt through 2003, excluding capital lease obligations, are 1999 — \$34 million; 2000 — \$4 million; 2001 — \$2 million; 2002 — \$2.72 billion; 2003 — \$1 million; and \$604 million thereafter.

## Note 10: Leases

We have non-cancelable commitments under both capital and long-term operating leases, primarily for our restaurants. Capital and operating lease commitments expire at various dates through 2087 and, in many cases, provide for rent escalations and renewal options. Most leases require us to pay related executory costs, which include property taxes, maintenance and insurance.

Future minimum commitments and sublease receivables under non-cancelable leases are set forth below:

	Commitments		Sublease Receivables	
	Capital	Operating	Direct Financing	Operating
1999	\$ 22	\$ 227	\$ 2	\$ 14
2000	21	194	2	12
2001	20	171	2	11
2002	18	152	2	9
2003	18	130	2	8
Thereafter	128	704	12	43
	<b>\$ 227</b>	<b>\$ 1,578</b>	<b>\$ 22</b>	<b>\$ 97</b>

At year-end 1998, the present value of minimum payments under capital leases was \$117 million, after deducting \$110 million representing imputed interest.

The details of rental expense and income are set forth below:

	1998	1997	1996
Rental expense			
Minimum	<b>\$ 308</b>	\$ 341	\$ 333
Contingent	<b>25</b>	30	32
	<b>\$ 333</b>	\$ 371	\$ 365
Minimum rental income	<b>\$ 18</b>	\$ 19	\$ 16

Contingent rentals are based on sales levels in excess of stipulated amounts contained in the lease agreements.

## Note 11: Financial Instruments

### DERIVATIVE INSTRUMENTS

Our policy prohibits the use of derivative instruments for trading purposes, and we have procedures in place to monitor and control their use. As of December 26, 1998, our use of derivative instruments was limited to interest rate swaps and collars entered into with financial institutions and commodity futures contracts traded on national exchanges.

We enter into interest rate swaps and collars with the objective of reducing our exposure to interest rate risk. During 1998 and 1997, we entered into interest rate swaps to effectively convert a portion of our variable rate bank debt to fixed rate. Reset dates and the floating rate indices on the swaps match those of the underlying bank debt. Accordingly, any market risk or opportunity associated with swaps is offset by the opposite market impact on the related debt. At December 26, 1998, we had outstanding interest rate swaps with notional amounts of \$1.2 billion. Under the contracts, we agree with other parties to exchange, at specified intervals, the difference between variable rate and fixed rate amounts calculated on a notional principal amount. At December 26, 1998, our average pay rate was 5.9%. Our payables under the related swaps aggregated \$1.6 million at December 26, 1998. The swaps mature at various dates through 2001.

During 1998, we entered into interest rate collars to reduce interest rate sensitivity on a portion of our variable rate bank debt. Interest rate collars effectively lock in a range of interest rates by establishing a cap and floor. Reset dates and the floating index on the collars match those of the underlying bank debt. If interest rates remain within the collared cap and floor, no payments are made. If rates rise above the cap level, we receive a payment. If rates fall below the floor level, we make a payment. At December 26, 1998, we had outstanding interest rate collars with notional amounts of \$700 million. Under the contracts, we agree with other parties to exchange, as required, the difference between the effective LIBOR rate and the cap or floor rate if the effective LIBOR rates fall outside the collared range. At December 26, 1998, our average pay rate on collars was 5.4%. Our payables under the related collars were immaterial and there were no related receivables at December 26, 1998. The collars mature at various dates through 1999.

Our credit risk from the swap and collar agreements is dependent both on the movement in interest rates and possibility of non-payment by counterparties. We mitigate credit risk by entering into these agreements with high-quality counterparties, netting swap payments within contracts and limiting payments associated with the collars to differences outside the collared range.

Open commodity futures contracts and deferred gains and losses at year-end 1998 and 1997, as well as gains and losses recognized as part of cost of sales in 1998, 1997 and 1996, were not significant.

#### FAIR VALUE

Excluding the financial instruments included in the table below, the carrying amounts of our financial instruments approximate fair value.

The carrying amounts and fair values of TRICON's financial instruments are as follows:

	1998		1997	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Debt				
Short-term borrowings and long-term debt, excluding capital leases	\$ 3,415	\$ 3,431	\$ 4,535	\$ 4,536
Debt-related derivative instruments				
Open contracts in liability position	2	17	—	2
Debt, excluding capital leases	\$ 3,417	\$ 3,448	\$ 4,535	\$ 4,538
Guarantees	\$ —	\$ 24	\$ —	\$ 18

We estimated the fair value of debt, debt-related derivative instruments and guarantees using market quotes and calculations based on market rates. See Note 18 for recently issued accounting pronouncements relating to financial instruments.

## Note 12: Pension Plans and Postretirement Medical Benefits

We sponsor noncontributory defined benefit pension plans covering substantially all full-time U.S. salaried employees and certain hourly employees and noncontributory defined benefit pension plans covering certain international employees. In addition, we provide postretirement health care benefits to eligible retired employees and their dependents, principally in the U.S. Salaried retirees who have 10 years of service and attain age 55 are eligible to participate in the postretirement benefit plans; since 1994, these plans have included retiree cost sharing provisions. Prior to the Spin-off, PepsiCo covered the participants with plans that had similar benefits. Under an agreement with PepsiCo, we have assumed or retained pension liabilities related to substantially all of our participants. Assets of the PepsiCo plans have been allocated and transferred in accordance with regulatory rules between the PepsiCo plans and our plans. We base benefits generally on years of service and compensation or stated amounts for each year of service.

# Change in benefit obligation

Benefit obligation at beginning of year

Service cost

Interest cost

Curtailment gain

Special termination benefits

Benefits and expenses paid

Actuarial loss (gain)

Benefit obligation at end of year

# Change in plan assets

Fair value of plan assets at beginning of year

Actual return on plan assets

Employer contributions

Benefits paid

Administrative expenses

Fair value of plan assets at end of year

# Reconciliation of funded status

Funded status

Unrecognized actuarial loss (gain)

Unrecognized transition asset

Unrecognized prior service costs

Net amount recognized at year-end

# Amounts recognized in the statement of financial position consist of:

Prepaid benefit cost

Accrued benefit liability

Accumulated other comprehensive income

Net amount recognized at year-end

Other comprehensive income attributable to

change in additional minimum liability recognition

# Additional year-end information for pension plans

with benefit obligations in excess of plan assets:

Benefit obligation

Fair value of plan assets

# Additional year-end information for pension plans

with accumulated benefit obligations in excess of plan assets:

Projected benefit obligation

Accumulated benefit obligation

Fair value of plan assets

Pension Benefits		Postretirement Medical Benefits	
1998	1997	1998	1997
<b>\$ 286</b>	\$ 210	<b>\$ 38</b>	\$ 31
21	18	2	2
20	17	3	2
—	—	(3)	—
1	1	1	—
(13)	(11)	(2)	(1)
—	51	(1)	4
<b>315</b>	286	<b>38</b>	38
<b>270</b>	224	—	—
1	57	—	—
1	1	—	—
(11)	(10)	—	—
(2)	(2)	—	—
<b>259</b>	270	—	—
<b>(56)</b>	(16)	<b>(38)</b>	(38)
11	(6)	(2)	—
—	(2)	—	—
2	3	(4)	(6)
<b>\$ (43)</b>	\$ (21)	<b>\$ (44)</b>	\$ (44)
<b>\$ —</b>	\$ 1	<b>\$ —</b>	\$ —
(46)	(22)	(44)	(44)
3	—	—	—
<b>\$ (43)</b>	\$ (21)	<b>\$ (44)</b>	\$ (44)
<b>\$ 3</b>	\$ (4)		
<b>\$ 315</b>	\$ 26		
<b>259</b>	—		
<b>\$ 46</b>	\$ 26		
<b>29</b>	7		
<b>15</b>	—		

#### Components of net periodic benefit cost

Service cost
Interest cost
Expected return on plan assets
Amortization of prior service cost
Amortization of transition (asset) obligation
Recognized actuarial (gain) loss
Net periodic benefit cost
Additional (gain) loss recognized due to:
Curtailment
Special termination benefits

The assumptions used to compute the information above are set forth below:

Discount rate — projected benefit obligation
Expected long-term rate of return on plan assets
Rate of compensation increase

Pension Benefits		Postretirement Medical Benefits	
1998	1997	1998	1997
\$ 21	\$ 18	\$ 2	\$ 2
20	17	3	2
(21)	(19)	—	—
—	—	(2)	(2)
(2)	(4)	—	—
2	1	—	—
\$ 20	\$ 13	\$ 3	\$ 2
\$ —	\$ —	\$ (3)	\$ —
3	2	1	—
6.8%	7.1%	7.0%	7.3%
10.0%	10.0%	—	—
4.5%	5.2 - 6.6%	4.5%	5.2%

We have assumed the annual increase in cost of postretirement medical benefits was 6.5% in 1998 and will be 6.5% in 1999. We are assuming the rate will decrease 0.5% for 2000 and 2001, reaching an ultimate rate of 5.5% in the year 2001 and remain at that level thereafter. We implemented a cap on our medical liability for certain retirees, which is expected to be reached between the years 2001-2004; at that point our cost will not increase.

Assumed health care cost trend rates have a significant effect on the amounts reported for our postretirement health care plans. The effects of a one percentage point increase or decrease in the assumed health care cost trend rates on postretirement benefit obligations are \$1.4 million and \$1.3 million, respectively. The effects of a one percentage point increase or decrease in the assumed health care cost trend rates on total service and interest cost components are not significant.

Accounting for pensions requires us to develop an assumed interest rate on securities with which the pension liabilities could be effectively settled. In estimating this discount rate, we look at rates of return on high-quality corporate fixed income securities currently available and expected to be available during the period to maturity of the pension benefits. As it is impractical to find an investment portfolio which exactly matches the estimated payment stream of the pension benefits, we often have projected short-term cash surpluses. In 1998, we changed the method for determining our pension and postretirement medical benefit discount rate to better reflect the assumed investment strategies we would most likely use to invest any short-term cash surpluses. Previously, we assumed that all short-term cash surpluses would be invested in U.S. government securities. Our new methodology assumes that our investment strategies would be equally divided between U.S. government securities and high-quality corporate fixed income securities. Our new methodology resulted in a reduction of approximately \$24 million in our 1998 accumulated benefit obligation as compared to the previous method. Our change in methodology had no effect on our 1998 net income.

### Note 13: Employee Stock-Based Compensation

At year-end 1998, we had three stock option plans in effect: the 1997 Long-Term Incentive Plan ("LTIP"), the TRICON Global Restaurants, Inc. Restaurant General Manager Stock Option Plan ("YUMBUCKS") and the TRICON Global Restaurants, Inc. SharePower Plan ("SharePower"). We may grant options to purchase up to 22.5 million shares of stock under the LTIP at a price equal to or greater than the average market price of the stock on the date of grant. New options we grant can have varying vesting provisions and exercise periods. Options granted vest in periods ranging from immediate to 2006 and expire ten to fourteen years after grant. Potential awards to employees and non-employee directors under the LTIP include stock options, performance restricted stock units, incentive stock options, stock appreciation rights and restricted stock. We have issued only stock options and performance restricted stock units under the LTIP. We may grant options to purchase up to 7.5 million shares of stock under YUMBUCKS at a price equal to or greater than the average market price of the stock on the date of grant. YUMBUCKS options granted have a four year vesting period and expire ten years after grant. We do not anticipate that any further grants will be made pursuant to the SharePower plan although options previously granted could be outstanding through 2006.

At the Spin-off Date, we converted certain of the unvested options to purchase PepsiCo stock that were held by our employees to TRICON stock options under either the LTIP or the SharePower plan. We converted the options at amounts and exercise prices that maintained the amount of unrealized stock appreciation that existed immediately prior to the Spin-off. The vesting dates and exercise periods of the options were not affected by the conversion. Based on their original PepsiCo grant date, our converted options vest in periods ranging from one to ten years and expire ten to fifteen years after grant.

Had we determined compensation cost for all TRICON option grants to employees and non-employee directors consistent with SFAS 123, our net income (loss) and basic and diluted earnings per Common Share would have been reduced (increased) to the pro forma amounts indicated below:

	1998	1997
Net Income (Loss)		
As reported	\$ 445	\$ (111)
Pro forma	422	(112)
Basic Earnings per Common Share		
As reported	\$ 2.92	
Pro forma	2.77	
Diluted Earnings per Common Share		
As reported	\$ 2.84	
Pro forma	2.70	

SFAS 123 pro forma loss per Common Share data for 1997 is not meaningful as we were not an independent, publicly owned company prior to the Spin-off.

The effects of applying SFAS 123 in the pro forma disclosures are not likely to be representative of the effects on pro forma net income for future years because variables such as the number of option grants, exercises and stock price volatility included in the disclosures may not be indicative of future activity.

We estimated the fair value of each option grant made during 1998 and 1997 subsequent to the Spin-off as of the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	1998	1997
Risk-free interest rate	5.5%	5.8%
Expected life (years)	6.0	6.6
Expected volatility	28.8%	27.5%
Expected dividend yield	0.0%	0.0%



A summary of the status of all options granted to employees and non-employee directors as of December 26, 1998 and December 27, 1997, and changes during the years then ended is presented below:

	December 26, 1998		December 27, 1997	
	Options	Wtd. Avg. Exercise Price	Options	Wtd. Avg. Exercise Price
Outstanding at beginning of year	15,245	\$ 23.03	—	\$ —
Conversion of PepsiCo options	—	—	13,951	21.48
Granted at price equal to average market price	12,084	29.37	872	32.95
Granted at price greater than average market price	—	—	1,334	31.63
Exercised	(962)	18.93	(112)	24.80
Forfeited	(3,668)	25.80	(800)	20.84
Outstanding at end of year	22,699	\$ 26.16	15,245	\$ 23.03
Exercisable at end of year	3,006	\$ 21.16	1,251	\$ 23.84
Weighted average of fair value of options granted	\$ 11.65		\$ 13.37	

The following table summarizes information about stock options outstanding and exercisable at December 26, 1998:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Options	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
\$0.01 - 17.80	2,944	5.83	\$ 15.01	1,417	\$ 14.34
22.02 - 29.40	13,339	8.10	25.67	1,212	25.76
30.41 - 34.47	5,803	9.27	31.71	366	31.63
35.13 - 43.88	613	9.71	37.66	11	43.88
	22,699			3,006	

In November 1997, we granted two awards of performance restricted stock units of TRICON's Common Stock to our Vice Chairman/President. The awards were made under the LTIP and may be paid in Common Stock of TRICON or cash at the discretion of the Board of Directors. Payments of the awards of \$2.7 million and \$3.6 million are contingent upon the Vice Chairman/President's continued employment through January 25, 2001 and 2006, respectively, and our attainment of

certain pre-established earnings thresholds, as defined. We expense these awards over the performance periods stipulated above; the amount included in earnings in 1998 and 1997 was \$1.3 million and \$150,000, respectively.

## Note 14: Other Compensation and Benefit Programs

We sponsor a contributory plan to provide retirement benefits under the provision of Section 401(k) of the Internal Revenue Code ("401(k) Plan") for eligible full-time U.S. salaried and certain hourly employees. Participants may elect to contribute up to 15% of their eligible compensation on a pretax basis. We are not required to make contributions to the Plan. In 1998, a Stock Ownership Program ("YUMSOP") was added to the TRICON Common Stock investment option. Under YUMSOP, we make a partial discretionary match of each participant's contribution to the TRICON Common Stock Fund. We determine our percentage match at the beginning of each year based on the immediate prior year performance of our Core Businesses.

In addition, we sponsor two deferred compensation benefit programs, the Executive Income Deferral Program and the Restaurant Deferred Compensation Plan (the "EID Plan" and the "RDC Plan") for eligible employees and non-employee directors. These plans allow participants to defer receipt of all or a portion of their annual salary and incentive compensation. As defined by the benefit programs, we credit the amounts deferred with earnings based on certain investment options selected by the participants. We expense the earnings amounts as incurred. Our obligations under these programs as of year-end 1998 and 1997 were \$70 million and \$37 million, respectively.

In late 1997, we introduced a new investment option for both benefit programs allowing participants to defer certain incentive compensation into the purchase of phantom shares of our Common Stock at a 25% discount from the average market price at the date of deferral. Participants bear the risk of forfeiture of both the discount and any amounts deferred if they voluntarily separate from employment during the two year vesting period. We expense the intrinsic value of the discount over the vesting period.

We will phase in certain structural changes to the EID Plan during 1999 and 2000. These changes include limiting phantom investment options, primarily to our Common Stock, and requiring the distribution of investments in the TRICON Common Stock option to be paid in shares of our Common Stock. Due to these structural changes, in 1998 we agreed to pay a one time premium on January 1, 2000 to participants with an account balance as of December 31, 1999. The premium payment will equal 10% of the

participant's account balance, excluding investments in discount stock option and 1999 deferrals, as of the date specified by the EID Plan.

During 1998, RDC participants also became eligible to purchase phantom shares of our Common Stock under YUMSOP as defined above.

We expensed \$22 million, including the estimated premium payment for the EID Plan, for 1998 and insignificant amounts for 1997 and 1996 for these programs.

## Note 15: Shareholders' Rights Plan

On July 21, 1998, our Board of Directors declared a dividend distribution of one right for each share of Common Stock outstanding as of August 3, 1998 (the "Record Date"). Each right initially entitles the registered holder to purchase a unit consisting of one one-thousandth of a share (a "Unit") of Series A Junior Participating Preferred Stock, without par value, at a purchase price of \$130 per Unit, subject to adjustment. The rights, which do not have voting rights, will become exercisable for our Common Stock ten business days following a public announcement that a person or group has acquired, or has commenced or intends to commence a tender offer for, 15% or more, or 20% or more if such person or group owned 10% or more on the adoption date of this plan, of our Common Stock. In the event the rights become exercisable for Common Stock, each right will entitle its holder (other than the Acquiring Person as defined in the Agreement) to purchase, at the right's then-current exercise price, TRICON Common Stock having a value of twice the exercise price of the right. In the event the rights become exercisable for Common Stock and thereafter we are acquired in a merger or other business combination, each right will entitle its holder to purchase, at the right's then-current exercise price, common stock of the acquiring company having a value of twice the exercise price of the right.

We can redeem the rights in their entirety, prior to becoming exercisable, at \$0.01 per right under certain specified conditions. The rights expire on July 21, 2008, unless we extend that date or we have earlier redeemed or exchanged the rights as provided in the Agreement.

This description of the rights is qualified in its entirety by reference to the Rights Agreement between TRICON and BankBoston, N.A., as Rights Agent, dated as of July 21, 1998 (including the exhibits thereto).

## Note 16: Income Taxes

The details of our income tax provision are set forth below:

	1998	1997	1996
Current: Federal	\$ 231	\$ 106	\$ 154
Foreign	55	77	93
State	22	31	28
	<b>308</b>	<b>214</b>	<b>275</b>
Deferred: Federal	(2)	(66)	(127)
Foreign	10	(59)	(5)
State	(5)	(13)	(18)
	<b>3</b>	<b>(138)</b>	<b>(150)</b>
	<b>\$ 311</b>	<b>\$ 76</b>	<b>\$ 125</b>

Our U.S. and foreign income (loss) before income taxes are set forth below:

	1998	1997	1996
U.S.	\$ 542	\$ 13	\$ (21)
Foreign	214	(48)	93
	<b>\$ 756</b>	<b>\$ (35)</b>	<b>\$ 72</b>

Our reconciliation of income taxes calculated at the U.S. Federal tax statutory rate to our income tax provision is set forth below:

	1998	1997	1996
Income taxes computed at the U.S. Federal statutory rate of 35%	\$ 265	\$ (12)	\$ 25
State income tax, net of Federal tax benefit	32	20	7
Foreign and U.S. tax effects attributable to foreign operations	31	24	49
Effect of unusual charges	(5)	79	28
Effect of the New Zealand IPO	—	(41)	—
Favorable adjustments relating to prior years	(32)	(3)	(1)
Nondeductible amortization of U.S. goodwill	9	6	9
Federal tax credits	(4)	(2)	(2)
Other, net	15	5	10
Income tax provision	<b>\$ 311</b>	<b>\$ 76</b>	<b>\$ 125</b>
Effective income tax rate	<b>41.1%</b>	<b>(217.1)%</b>	<b>173.6%</b>

The details of our 1998 and 1997 deferred tax liabilities (assets) are set forth below:

	1998	1997
Intangible assets and property, plant and equipment	\$ 243	\$ 253
Other	8	5
Gross deferred tax liabilities	<b>\$ 251</b>	<b>\$ 258</b>
Net operating loss and tax credit carryforwards	<b>\$ (107)</b>	<b>\$ (89)</b>
Employee benefits	(58)	(48)
Self-insured casualty claims	(46)	(57)
Stores held for disposal	(62)	(105)
Various liabilities and other	(183)	(141)
Gross deferred tax assets	<b>(456)</b>	<b>(440)</b>
Deferred tax assets		
valuation allowance	133	111
Net deferred tax assets	<b>(323)</b>	<b>(329)</b>
Net deferred tax (asset) liability	<b>\$ (72)</b>	<b>\$ (71)</b>
Included in:		
Prepaid expenses, deferred income taxes and other current assets	<b>\$ (137)</b>	<b>\$ (92)</b>
Other assets	—	(12)
Deferred income taxes	65	33
	<b>\$ (72)</b>	<b>\$ (71)</b>

Our valuation allowance related to deferred tax assets increased by \$22 million in 1998 primarily due to additions related to current year operating losses and temporary differences in a number of foreign and state jurisdictions.

A determination of the unrecognized deferred tax liability for temporary differences related to our investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration is not practicable.

We have available net operating loss carryforwards totaling \$625 million at year-end 1998 to reduce future tax of TRICON and certain subsidiaries. The carryforwards are related to a number of foreign and state jurisdictions. Of these carryforwards, \$37 million expire in 1999 and \$554 million expire at various times between 2000 and 2013. The remaining \$34 million of carryforwards do not expire.

## Note 17: Reportable Operating Segments

We are engaged principally in developing, operating, franchising and licensing the worldwide KFC, Pizza Hut and Taco Bell concepts. We also previously operated the Non-core Businesses, all of which were sold in 1997 prior to the Spin-off.

KFC, Pizza Hut and Taco Bell operate throughout the U.S. and in 80, 88 and 12 countries and territories outside the U.S., respectively. Principal international markets include Australia, Canada, China, Japan, Mexico, Puerto Rico and the U.K. At year-end 1998, we had 12 investments in unconsolidated affiliates outside the U.S. which operate KFC and/or Pizza Hut restaurants, the most significant of which are corporate joint ventures located in Japan, the U.K. and China.

We identify our operating segments based on management responsibility within the U.S. and International. For purposes of applying SFAS 131, we consider our U.S. Core Businesses to be similar and have aggregated them into a single reportable operating segment. Other than the U.S., no individual country represented 10% or more of our total revenues, profits or assets.

Revenues				Identifiable Assets			
	1998	1997	1996		1998	1997	1996
United States	\$ 6,428	\$ 7,365	\$ 7,924	United States	\$ 2,942	\$ 3,388	\$ 4,566
International	2,040	2,320	2,308	International <sup>(a)</sup>	1,447	1,479	1,954
	<b>\$ 8,468</b>	<b>\$ 9,685</b>	<b>\$ 10,232</b>	Corporate <sup>(a)</sup>	142	247	—
					<b>\$ 4,531</b>	<b>\$ 5,114</b>	<b>\$ 6,520</b>
Operating Profit, Interest Expense, Net and Income Before Income Taxes				Depreciation and Amortization			
	1998	1997	1996		1998	1997	1996
United States	\$ 740	\$ 603 <sup>(b)</sup>	\$ 505 <sup>(b)</sup>	United States	\$ 300	\$ 388	\$ 472
International <sup>(a)</sup>	191	172	155	International	104	143	149
Facility actions net gain (loss) <sup>(c)</sup>	275	(247)	37	Corporate	13	5	—
Unusual charges <sup>(d)</sup>	(15)	(184)	(246)		<b>\$ 417</b>	<b>\$ 536</b>	<b>\$ 621</b>
Foreign exchange gain (loss)	6	(16)	(5)				
Unallocated and corporate expenses	(169) <sup>(e)</sup>	(87) <sup>(e)</sup>	(74) <sup>(e)</sup>	Capital Spending			
Total Operating Profit	<b>1,028</b>	<b>241</b>	<b>372</b>		<b>1998</b>	<b>1997</b>	<b>1996</b>
Interest expense, net	272	276 <sup>(f)</sup>	300 <sup>(f)</sup>	United States	\$ 305	\$ 381	\$ 462
Income (loss) before income taxes	<b>\$ 756</b>	<b>\$ (35)</b>	<b>\$ 72</b>	International	150	157	158
				Corporate	5	3	—
					<b>\$ 460</b>	<b>\$ 541</b>	<b>\$ 620</b>

(a) Results from the United States in 1997 and 1996 included the Non-core Businesses disposed of in 1997. Excluding the unusual disposal charges, the Non-core Businesses contributed the following:

	1997	1996
Revenues	\$ 268	\$ 394
Operating profit (loss)	13	(10)
Interest expense, net	3	5
Income before income taxes	10	(15)

(b) Included equity income of unconsolidated affiliates of \$18 million, \$8 million and \$7 million in 1998, 1997 and 1996, respectively.

(c) See Note 4 for a discussion and breakout by reportable operating segment of facility actions net gain (loss) and unusual charges.

(d) Corporate and unallocated expenses increased in 1993 primarily due to spending on Year 2000 compliance and remediation efforts, costs to relocate our processing center from Wichita to other facilities and expenses incurred as an independent, publicly owned company as well as additional expenses related to the efforts to improve and standardize our operating, administrative and accounting systems.

(e) Included amounts allocated by PepsiCo prior to the Spin-off of \$37 million and \$53 million in 1997 and 1996, respectively, related to general and administrative expenses and \$148 million and \$275 million in 1997 and 1996, respectively, related to interest expense.

(f) Included investment in unconsolidated affiliates of \$159 million, \$143 million and \$228 million for 1998, 1997 and 1996, respectively.

(g) Included restricted cash, capitalized debt issuance costs, advances to our voluntary employees' beneficiary association trust, leasehold improvements in certain of our office facilities and non-core assets held for sale.

See Note 4 for additional operating segment disclosures related to impairment, suspension of depreciation and amortization and the carrying amount of assets held for disposal.

The 1997 and 1996 financial data we reported above are materially consistent with restaurant segment information previously reported by PepsiCo. We made adjustments to these amounts primarily to remove the impact of the restaurant distribution business previously included by PepsiCo in its restaurant segment, and to include the investment in and our equity income (loss) of unconsolidated affiliates within the international segment. We made this change to align our reporting with the way we internally review and make decisions regarding our international business.

## Note 18: New Accounting Pronouncements Not Yet Adopted

### ACCOUNTING FOR THE COSTS OF COMPUTER SOFTWARE DEVELOPED OR OBTAINED FOR INTERNAL USE

Statement of Position 98-1 (SOP 98-1), "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," was issued in March 1998. SOP 98-1 identifies the characteristics of internal-use software and specifies that once the preliminary project stage is complete, certain external direct costs, certain direct internal payroll and payroll-related costs and interest costs incurred during the development of computer software for internal use should be capitalized and amortized. SOP 98-1 is effective for financial statements for fiscal years beginning after December 15, 1998 and must be applied to internal-use computer software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of this SOP. We currently expense all these costs as incurred.

### ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). This Statement establishes accounting and reporting standards requiring that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair value. This Statement requires that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. Special accounting for qualifying hedges allows a derivative's gains and losses to offset the related change in fair value on the hedged item in the income statement, and requires that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting.

SFAS 133 is effective for fiscal years beginning after June 15, 1999. A company may also implement the Statement as of the beginning of any fiscal quarter after issuance (that is, fiscal quarters beginning June 16, 1998 and thereafter). SFAS 133 cannot be applied retroactively. When adopted, SFAS 133 must be applied to (a) derivative instruments and (b) certain derivative instruments embedded in hybrid contracts that were issued, acquired, or substantively modified after December 31, 1997 (and, at the company's election, before January 1, 1998).

We have not yet quantified the effects of adopting SFAS 133 on our financial statements or determined the timing of or method of our adoption of SFAS 133. However, the Statement could increase volatility in our earnings and other comprehensive income.

## Note 19: Commitments and Contingencies

### RELATIONSHIP WITH PEPSICO AFTER SPIN-OFF

After the Spin-off, PepsiCo had no ownership interest in us. Immediately after the Spin-off, however, certain of our shares were held by the PepsiCo pension trust on behalf of PepsiCo employees. We entered into separation and other related agreements (the "Separation Agreement"), outlined below, governing the Spin-off transaction and our subsequent relationship with PepsiCo. These agreements provide certain indemnities to the parties, and provide for the allocation of tax and other assets, liabilities and obligations arising from periods prior to the Spin-off. In addition, prior to the Spin-off, our U.S. Core Businesses each entered into a multi-year agreement with Pepsi-Cola Company, a wholly owned subsidiary of PepsiCo, regarding the purchase of beverage products. Prior to the Spin-off and PepsiCo's sale to Ameriserve of PFS, our primary U.S. food and supplies distributor, our Core Businesses signed a multi-year distribution agreement with PFS. Neither contract is for quantities expected to exceed normal usage.

The Separation Agreement provided for, among other things, our assumption of all liabilities relating to the restaurant businesses, inclusive of the Non-core Businesses, and our indemnification of PepsiCo with respect to these liabilities. We have included our best estimates of these liabilities in the accompanying Consolidated Financial Statements. Subsequent to Spin-off, claims have been made by certain Non-core Business franchisees and a purchaser of one of the businesses. We are disputing the validity of these claims; however, we believe that any settlement of these claims at amounts in excess of previously recorded liabilities is not likely to have a material adverse effect on our results of operations, financial condition or cash flows.

In addition, we must pay a fee to PepsiCo for all letters of credit, guarantees and contingent liabilities relating to our businesses under which PepsiCo remains liable. This obligation ends at the time they are released, terminated or replaced by a qualified letter of credit covering the full amount of contingencies under the letters of credit, guarantees and contingent liabilities. Our fee payments to PepsiCo during 1998 were immaterial. We have also indemnified PepsiCo for any costs or losses it incurs with respect to these letters of credit, guarantees and contingent liabilities.

Under the separation agreements, PepsiCo maintains full control and absolute discretion with regard to any combined or consolidated tax filings for periods through the Spin-off Date. PepsiCo also maintains full control and absolute discretion regarding any common tax audit issues. Although PepsiCo has contractually agreed to, in good faith, use its best efforts to settle all joint interests in any common audit issue on a basis consistent with prior practice, there can be no assurance that determinations made by PepsiCo would be the same as we would reach, acting on our own behalf. We have agreed to certain restrictions on future actions to help



ensure that the Spin-off maintains its tax-free status. Our restrictions include, among other things, limitations on our liquidation, merger or consolidation with another company, certain issuances and redemptions of our Common Stock, our granting of stock options and our sale, refranchising, distribution or other disposition of assets. If we fail to abide by these restrictions or to obtain waivers from PepsiCo and, as a result, the Spin-off fails to qualify as a tax-free reorganization, we will be obligated to indemnify PepsiCo for any resulting tax liability which could be substantial. We have not been required to make any payments under these indemnities. Additionally, under the terms of the tax separation agreement, PepsiCo is entitled to the federal income tax benefits related to the exercise after the Spin-off of vested PepsiCo options held by our employees.

## OTHER COMMITMENTS AND CONTINGENCIES

We were directly or indirectly contingently liable in the amounts of \$327 million and \$302 million at year-end 1998 and 1997, respectively, for certain lease assignments and guarantees. In connection with these contingent liabilities, after the Spin-off Date, we were required to maintain cash collateral balances at certain institutions of approximately \$30 million, which is included in Other Assets in the accompanying Consolidated Balance Sheet. At year-end 1998, \$261 million represented contingent liabilities to lessors as a result of assigning our interest in and obligations under real estate leases as a condition to the refranchising of Company restaurants. The \$261 million represented the present value of the minimum payments of the assigned leases, excluding any renewal option periods, discounted at our pre-tax cost of debt. On a nominal basis, the contingent liability resulting from the assigned leases was \$385 million. The balance of the contingent liabilities primarily reflected guarantees to support financial arrangements of certain unconsolidated affiliates and other restaurant franchisees.

We are currently, and for a significant portion of the three years ended December 26, 1998, have been, effectively self-insured for most workers' compensation, general liability and automobile liability losses, subject to per occurrence and aggregate annual liability limitations. During the first two quarters of 1997, prior to the Spin-off, we participated with PepsiCo in a guaranteed cost program for certain coverages. We are also effectively self-insured for health care claims for eligible participating employees subject to certain deductibles and limitations. We determine our liabilities for claims reported and for claims incurred but not reported based on information provided by independent actuaries.

In July 1998, we entered into severance agreements with certain key executives which are triggered by a termination, under certain conditions, of the executive following a change in control of the Company, as defined in the agreements. Once triggered, the affected executives would receive twice the amount of their annual base salary and their annual incentive in a lump sum, outplacement services and a tax gross-up for any excise taxes. The agreements expire December 31, 2000. Since the timing of any payments under these agreements cannot be anticipated, the amounts are not estimable. However, these payments, if made, could be substantial. In connection with the execution of these agreements, the Compensation Committee of our Board of Directors has authorized amendment of the deferred and incen-

tive compensation plans and, following a change in control, an establishment of rabbi trusts which will be used to provide payouts under these deferred compensation plans following a change in control.

We are subject to various claims and contingencies related to lawsuits, taxes, environmental and other matters arising out of the normal course of business. Like some other large retail employers, Pizza Hut and Taco Bell recently have been faced in a few states with allegations of purported class-wide wage and hour violations.

On May 11, 1998, a purported class action lawsuit against Pizza Hut, Inc., and one of its franchisees, PacPizza, LLC, entitled *Aguardo, et al. v. Pizza Hut, Inc., et al.* ("*Aguardo*"), was filed in the Superior Court of the State of California of the County of San Francisco. The lawsuit was filed by three former Pizza Hut restaurant general managers purporting to represent approximately 1,300 current and former California restaurant general managers of Pizza Hut and PacPizza. The lawsuit alleges violations of state wage and hour laws involving unpaid overtime wages and vacation pay and seeks an unspecified amount in damages. This lawsuit is in the early discovery phase. A trial date of October 28, 1999 has been set.

On October 2, 1996, a class action lawsuit against Taco Bell Corp., entitled *Mynaf, et al. v. Taco Bell Corp.* ("*Mynaf*"), was filed in the Superior Court of the State of California of the County of Santa Clara. The lawsuit was filed by two former restaurant general managers and two former assistant restaurant general managers purporting to represent all current and former Taco Bell restaurant general managers and assistant restaurant general managers in California. The lawsuit alleges violations of California wage and hour laws involving unpaid overtime wages. The complaint also includes an unfair business practices claim. The four named plaintiffs claim individual damages ranging from \$10,000 to \$100,000 each. On September 17, 1998, the court certified a class of approximately 3,000 current and former assistant restaurant general managers and restaurant general managers. Taco Bell petitioned the appellate court to review the trial court's certification order. The petition was denied on December 31, 1998. Taco Bell has filed a petition for review to the California Supreme Court which is currently pending. No trial date has been set.

Plaintiffs in the *Aguardo* and *Mynaf* lawsuits seek damages, penalties and costs of litigation, including attorneys' fees, and also seek declaratory and injunctive relief. We intend to vigorously defend these lawsuits. However, the outcome of these lawsuits cannot be predicted at this time. We believe that the ultimate liability, if any, arising from such claims or contingencies is not likely to have a material adverse effect on our annual results of operations, financial condition or cash flows. It is, however, reasonably possible that any ultimate liability could be material to our year-over-year growth in earnings in the quarter and year recorded.

On August 29, 1997, a class action lawsuit against Taco Bell Corp., entitled *Bravo, et al. v. Taco Bell Corp.* ("*Bravo*"), was filed in the Circuit Court of the State of Oregon of the County of Multnomah. The lawsuit was filed by two former Taco Bell shift managers purporting to represent approximately 16,000 current and former hourly employees statewide. The lawsuit alleges

violations of state wage and hour laws, principally involving unpaid wages including overtime, and rest and meal period violations, and seeks an unspecified amount in damages. Under Oregon class action procedures, Taco Bell was allowed an opportunity to "cure" the unpaid wage and hour allegations by opening a claims process to all putative class members prior to certification of the class. In this cure process, Taco Bell has currently paid out less than \$1 million. On January 26, 1999, the Court certified a class of all current and former shift managers and crew members who claim one or more of the alleged violations.

On February 10, 1995, a class action lawsuit, entitled *Ryder, et al. v. Taco Bell Corp.* ("Ryder"), was filed in the Superior Court of the State of Washington for King County on behalf of approximately 16,000 current and former Taco Bell employees claiming unpaid

wages resulting from alleged uniform, rest and meal period violations and unpaid overtime. In April 1996, the Court certified the class for purposes of injunctive relief and a finding on the issue of liability. The trial was held during the first quarter of 1997 and resulted in a liability finding. In August 1997, the Court certified the class for purposes of damages as well. Prior to the damages phase of the trial, the parties reached a court-approved settlement process in April 1998.

We have provided for the estimated costs of the *Bravo* and *Ryder* litigations, based on a projection of eligible claims, the cost of each eligible claim and the estimated legal fees incurred by plaintiffs. We believe the ultimate cost of the *Bravo* and *Ryder* cases in excess of the amounts already provided will not be material to our annual results of operations, financial condition, or cash flows.

## Note 20: Selected Quarterly Financial Data (Unaudited)

### Revenues:

Company sales	
Franchise and license fees	
Total costs and expenses	
Operating profit	
Net income	
Income per common share — diluted	

### Operating profit (loss) attributable to:

Facility actions net gain	
Unusual (charges) credits	

### Net income (loss) attributable to:

Facility actions net gain	
Unusual (charges) credits	

1998				
First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
\$ 1,790	\$ 1,867	\$ 1,869	\$ 2,326	\$ 7,852
132	136	148	200	616
1,754	1,741	1,738	2,207	7,440
168	262	279	319	1,028
54	112	128	151	445
.35	.72	.82	.95	2.84
29	73	54	119	275
—	—	5	(20)	(15)
16	42	34	70	162
—	—	3	(6)	(3)

### Revenues:

Company sales	
Franchise and license fees	
Total costs and expenses	
Operating profit (loss)	
Net income (loss)	
Loss per share — basic	

### Operating profit (loss) attributable to:

Facility actions net gain (loss)	
Unusual charges	

### Net income (loss) attributable to:

Facility actions net gain (loss)	
Unusual charges	

1997				
First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
\$ 2,123	\$ 2,214	\$ 2,162	\$ 2,613	\$ 9,112
114	140	138	181	573
2,075	2,122	2,105	3,142	9,444
162	232	195	(348)	241
52	121	79	(363)	(111)
—	—	—	(2.39)	—
12	73	51	(383)	(247)
—	(39)	(15)	(130)	(184)
6	65	43	(277)	(163)
—	(22)	(12)	(131)	(165)

24 Earnings per share data has not been provided for periods prior to the fourth quarter of 1997 as our capital structure as an independent, publicly owned company did not exist prior to the Spin-off.

See Note 4 for details of facility actions net gain (loss) and unusual charges.

## Management's Responsibility for Financial Statements

### TO OUR SHAREHOLDERS:

We are responsible for the preparation, integrity and fair presentation of the Consolidated Financial Statements, related notes and other information included in this annual report. The financial statements were prepared in accordance with generally accepted accounting principles and include certain amounts based upon our estimates and assumptions, as required. Other financial information presented in the annual report is derived from the financial statements.

We maintain a system of internal control over financial reporting, designed to provide reasonable assurance as to the reliability of the financial statements, as well as to safeguard assets from unauthorized use or disposition. The system is supported by formal policies and procedures, including an active Code of Conduct program intended to ensure employees adhere to the highest standards of personal and professional integrity. Our internal audit function monitors and reports on the adequacy of and compliance with the internal control system, and appropriate actions are taken to address significant control deficiencies and other opportunities for improving the system as they are identified.

The financial statements have been audited and reported on by our independent auditors, KPMG LLP, who were given free access to all financial records and related data, including minutes of the meetings of the Board of Directors and Committees of the Board. We believe that management representations made to the independent auditors were valid and appropriate.

The Audit Committee of the Board of Directors, which is composed solely of outside directors, provides oversight to our financial reporting process and our controls to safeguard assets through periodic meetings with our independent auditors, internal auditors and management. Both our independent auditors and internal auditors have free access to the Audit Committee.

Although no cost-effective internal control system will preclude all errors and irregularities, we believe our controls as of December 26, 1998 provide reasonable assurance that our assets are reasonably safeguarded.



**Robert C. Lowes**  
Chief Financial Officer



## Report of Independent Auditors

### THE BOARD OF DIRECTORS

### TRICON GLOBAL RESTAURANTS, INC.:

We have audited the accompanying consolidated balance sheet of TRICON Global Restaurants, Inc. and Subsidiaries ("TRICON") as of December 26, 1998 and December 27, 1997, and the related consolidated statements of operations, cash flows and shareholders' (deficit) equity and comprehensive income for each of the years in the three-year period ended December 26, 1998. These consolidated financial statements are the responsibility of TRICON's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of TRICON as of December 26, 1998 and December 27, 1997, and the results of its operations and its cash flows for each of the years in the three-year period ended December 26, 1998, in conformity with generally accepted accounting principles.

**KPMG LLP**

**KPMG LLP**

Louisville, Kentucky

February 10, 1999

# Selected Financial Data

TRICON Global Restaurants, Inc. and Subsidiaries

(In millions, except per share and unit amounts)

	Fiscal Year Ended				
	1998	1997	1996	1995	1994 <sup>1</sup>
<b>Summary of Operations</b>					
System sales (excluding Non-core Businesses, rounded)					
U.S.	\$ 14,000	13,500	13,400	13,200	12,600
International	6,600	7,000	6,900	6,500	5,600
Total	\$ 20,600	20,500	20,300	19,700	18,200
Revenues					
Company sales	\$ 7,852	9,112	9,738	9,813	9,170
Franchise and license fees	616	573	494	437	395
Total	\$ 8,468	9,685	10,232	10,250	9,565
Facility actions net gain (loss) <sup>2</sup>	\$ 275	(247)	37	(402)	(10)
Unusual charges <sup>3</sup>	\$ 15	184	246	—	—
Operating profit	\$ 1,028	241	372	252	582
Interest expense, net	272	276	300	355	341
Income (loss) before income taxes <sup>4</sup>	756	(35)	72	(103)	241
Net income (loss) <sup>1,2,4</sup>	\$ 445	(111)	(53)	(132)	118
Basic earnings per common share <sup>5</sup>	\$ 2.92	N/A	N/A	N/A	N/A
Diluted earnings per common share <sup>5</sup>	\$ 2.84	N/A	N/A	N/A	N/A
<b>Cash Flow Data</b>					
Provided by operating activities	\$ 674	810	713	813	894
Capital spending	\$ 460	541	620	701	1,038
Refranchising of restaurants	\$ 784	770	355	165	—
<b>Balance Sheet</b>					
Total assets	\$ 4,531	5,114	6,520	6,908	7,387
Operating working capital deficit	\$ (960)	(1,073)	(915)	(925)	(1,007)
Long-term debt	\$ 3,436	4,551	231	260	267
Total debt	\$ 3,532	4,675	290	404	395
Investments by and advances from PepsiCo	\$ —	—	4,266	4,604	4,962
<b>Other Data</b>					
Number of stores at year-end					
Franchised and licensed	20,246	18,505	16,213	14,428	13,003
Company, including joint ventures	9,517	11,207	12,883	13,466	13,209
System	29,763	29,712	29,096	27,894	26,212
U.S. Company same store sales growth					
KFC	3%	2%	6%	7%	2%
Pizza Hut	6%	(1)%	(4)%	4%	(6)%
Taco Bell	3%	2%	(2)%	(4)%	2%
Shares outstanding at year-end (in millions)	153	152	N/A	N/A	N/A
Market price per share at year-end	\$ 47 5/8	28 5/16	N/A	N/A	N/A

N/A - Not Applicable.

TRICON Global Restaurants, Inc. and Subsidiaries ("TRICON") became an independent, publicly owned company on October 6, 1997 through the spin-off of the restaurant operations of its former parent, PepsiCo, Inc., to its shareholders. The historical consolidated financial data for 1997 and the prior years above were prepared as if we had been an independent, publicly owned company for all periods presented. The selected financial data should be read in conjunction with the Consolidated Financial Statements and the Notes thereto.

(1) Fiscal year 1994 consisted of 53 weeks. The fifty-three week increased 1994 revenues by \$172 million and earnings by approximately \$23 million (\$14 million after-tax).

(2) Includes \$54 million (\$33 million after-tax) of favorable adjustments to our 1997 fourth quarter charge in 1996, \$412 million (\$303 million after-tax) related to our fourth quarter charge in 1997 and \$457 million (\$324 million after-tax) related to the early adoption of Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment Of Long-Lived Assets and For Long-Lived Assets to Be Disposed Of" in 1995.

(3) Includes \$11 million (\$7 million after-tax) of favorable adjustments to our 1997 fourth quarter charge in 1996, \$126 million (\$125 million after-tax) related to 1997 fourth quarter charges and an additional \$54 million (\$34 million after-tax) related to the 1991 disposal of the Non-core Businesses. 1996 includes \$246 million (\$189 million after-tax) write-down of our Non-core Businesses. See Note 4 to the Consolidated Financial Statements.

(4) EPS data is omitted for 1997 and the prior years as our capital structure as an independent, publicly owned company did not exist.

# Shareholder Information

## ANNUAL MEETING

The Annual Meeting of Shareholders will be at TRICON's headquarters, Louisville, KY at 9:00 a.m. (EDT), Thursday, May 20, 1999. Proxies for the meeting will be solicited by an independent proxy solicitor. This Annual Report is not part of the proxy solicitation.

## INQUIRIES REGARDING YOUR STOCK HOLDINGS

Registered Shareholders (shares held by you in your name) should address communications concerning statements, dividend payments, address changes, lost certificates and other administrative matters to:

TRICON Global Restaurants, Inc.  
c/o Boston Equiserve, L.P.  
P.O. Box 8038  
Boston, MA 02266-8038  
(888) 439-4986

or

James B. Alterman  
Manager, Shareholder Relations  
TRICON Global Restaurants, Inc.  
1441 Gardiner Lane  
Louisville, KY 40213  
Telephone: (888) 2YUMYUM  
EMAIL: james.alterman@tricon-yum.com  
Internet: www.triconglobal.com

In all correspondence or telephone inquiries, please mention TRICON, your name as printed on your statement or stock certificate, your social security number, your address and telephone number.

**BENEFICIAL SHAREHOLDERS** (shares held in the name of your bank or broker) should direct communications on all administrative matters to your stockbroker.

**TRICON YUMBUCKS AND SHAREPOWER PARTICIPANTS** (employees with YUMBUCKS shares or SharePower options) should address all questions regarding your account, outstanding options or shares received through option exercises to:

Merrill Lynch - SharePower/YUMBUCKS  
Stock Option Plan Services  
P.O. Box 30466  
New Brunswick, NJ 08989-0446  
Telephone: (800) 637-2432 (U.S., Puerto Rico and Canada)  
(732) 560-9444 (all other locations)

In all correspondence, please provide your account number (for U.S. citizens, this is your social security number), your address, your telephone number and mention either TRICON YUMBUCKS or SharePower. For telephone inquiries, please have a copy of your most recent statement available.

## EMPLOYEE BENEFIT PLAN PARTICIPANTS

Capital Stock Purchase Plan	(888) 875-4015
SaveUp 401(k)	(888) 875-4015
TRICON Savings Center	(617) 847-1013
P.O. Box 1389	(outside U.S.)
Boston, MA 02104-1389	

Please have a copy of your most recent statement available when calling. Press \*0 for a customer service representative and give the representative the name of the Plan.

# Shareholder Services

## OPTIONAL CASH INVESTMENT

A brochure explaining this convenient plan is available from our transfer agent:

Boston Equiserve, L.P.  
P.O. Box 8038  
Boston, MA 02266-8038 (888) 439-4986

## LOW-COST INVESTMENT PLAN

Investors may purchase their initial share of stock through NAIC's Low-Cost Investment Plan. For details contact:  
National Association of Investors Corporation (NAIC)  
711 West Thirteen Mile Road  
Madison Heights, MI 48071  
(810) 583-NAIC (6242)



## FINANCIAL AND OTHER INFORMATION

Earnings and other financial results, corporate news, and other company information are available on TRICON's web site:  
[www.triconglobal.com](http://www.triconglobal.com)

Copies of TRICON's SEC Form 8-K, 10-K and 10-Q reports and quarterly earnings releases are available free of charge. Contact TRICON's Manager of Shareholder Relations at (888) 2YUMYUM or EMAIL james.alterman@tricon-yum.com

Securities analysts, portfolio managers, representatives of financial institutions and other individuals with questions regarding TRICON's performance are invited to contact:

Lynn A. Tyson  
Vice President, Investor Relations  
TRICON Global Restaurants, Inc.  
Louisville, KY 40213  
Telephone: (502) 874-8617

## INDEPENDENT AUDITORS

KPMG LLP  
400 West Market Street, Suite 2600  
Louisville, KY 40202  
Telephone: (502) 587-0535

# Capital Stock Information

## STOCK TRADING SYMBOL — YUM

The New York Stock Exchange is the principal market for TRICON Common stock.



## SHAREHOLDERS

At year-end 1998, there were approximately 175,000 shareholders of record.

## DIVIDEND POLICY

TRICON does not currently pay dividends, nor does it anticipate doing so in the near future.

TRICON's Annual Report contains many of the valuable trademarks owned and used by TRICON and subsidiaries and affiliates in the United States and internationally.

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Design: Belk Mignogna Associates, New York

## Board of Directors

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Co-Chief Executive Officer of Salomon  
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Italia, a luxury goods producer  
and retailer

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**Andrall E. Pearson, 73**  
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Tricon

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Management Corporation, one of  
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## Officers

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International

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Tricon

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Counsel and Secretary, Tricon

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Tricon

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Taco Bell USA

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Manager, Tricon Restaurants  
International

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**Robert C. Lowes, 53**  
Chief Financial Officer, Tricon

**Charles E. Rawley, 48**  
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Officer, KFC USA

**Michael S. Rawlings, 44**  
President and Chief Concept Officer,  
Pizza Hut USA

**Peter C. Waller, 44**  
President and Chief Concept Officer,  
Taco Bell USA

**Sandra S. Wijnberg, 42**  
Senior Vice President and Treasurer,  
Tricon

## Franchisee Advisory Council

**Linda Alvarado**  
Taco Bell

**Allen Beebe**  
Taco Bell

**Percy Fennell**  
KFC

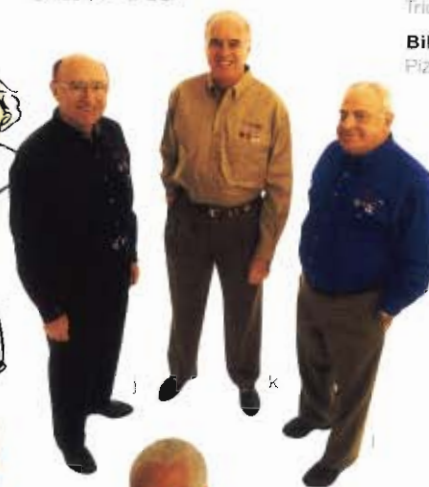
**Dick Freeland**  
Pizza Hut

**Arthur Ho**  
Tricon Restaurants International

**Al Luihn**  
KFC

**Keith Sole**  
Tricon Restaurants International

**Bill Walsh**  
Pizza Hut



## BOARD OF DIRECTORS

row left to right: (a) Jackie Trujillo, (b) Kenneth G. Langone, (c) Massimo Ferragamo, (d) Robert Holland, Jr., (e) David C. Novak, (f) Andrall E. Pearson,  
row left to right: (g) Robert J. Ulrich, (h) Jeanette S. Wagner, (i) James Dimon, (j) Sidney Kohl, (k) D. Ronald Daniel, (l) John L. Weinberg



We do  
chicken right!



Best pizzas  
under one roof!

Yo Quiero  
Taco Bell!



Alone we're delicious,  
together we're YUM!

Tricon Yum!